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THE 1977 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

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THE 1977 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 7, 1977

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 345, Cannon House Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling and Moorhead; and Senators Humphrey and Javits.

Also present: Louis C. Krauthoff II and Courtenay M. Slater, assistant directors; William A. Cox, Robert D. Hamrin, Kent H. Hughes, John R. Karlik, L. Douglas Lee, and Katie MacArthur, professional staff members; Michael J. Runde, administrative assistant; and Stephen J. Entin, George D. Krumbhaar, Jr., M. Catherine Miller, and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, CHAIRMAN

Representative BOLLING. The committee will come to order.

This committee has heard testimony on the economic situation from the top economic advisers of both President Ford and President Carter. Last week we heard from Mr. Blumenthal, the new Secretary of the Treasury, and Mr. Schultze, President Carter's new Chairman of the CEA and they agreed that the Nation's recent and prospective economic performance implies a need for immediate new fiscal stimulus. Although Messrs. Greenspan and Malkiel would shape the stimulus package differently—with more emphasis on permanent tax reduction than President Carter's recommendations contain—they concurred that stimulus is needed and that its proposed size is reasonable.

However, Chairman Burns of the Federal Reserve Board, told the House Budget Committee last week that in his judgment the economy is improving on its own and that it is not clear that any stimulus is needed at all. Mr. Burns assured the committee that the Federal Reserve would not counteract the proposed fiscal measures, however, he stated that the stimulus package could cause interest rates to rise.

Against this background, the committee turns this week to testimony by economic experts in the private sector. Today we have with us two former Presidents of the American Economic Association, Prof. Walter Heller of the University of Minnesota, who chaired President Kennedy's Council of Economic Advisers, and Prof. Franco Modigliani of the Massachusetts Institute of Technology. These two eminent gentlemen are joined by Mr. Henry Haufman, a partner at Salomon Bros., prominent New York investment bankers.

Tomorrow we shall welcome a panel of economists who will discuss the outlook with emphasis on the international trade and financial issues, and on Wednesday we look forward to hearing from a group of business and labor leaders.

Let us now proceed with today's testimony. Professor Heller, will you begin.

We will proceed now informally or formally as you desire, and we will start with Walter Heller.

STATEMENT OF WALTER W. HELLER, REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. HELLER. Mr. Chairman, I would prefer to read my prepared statement.

Representative BOLLING. Please proceed in any manner you wish.

Mr. HELLER. It is a pleasure and privilege—as it has been for over 25 years—to appear before the Joint Economic Committee, especially at a time when an attempt on its life—in the name of senatorial streamlining—has been thwarted. The committee plays a unique role in airing vital economic issues, sponsoring policy-oriented research, and promoting congressional and public understanding of the economy's problems. Long may it live.

Right now, the big economic issues before the House and Senate are the laggard economic recovery, aggravated by the low blow of a bitter winter, and the aptness of President Carter's stimulus program.

Since the need for that program has been seriously questioned by the widely respected Chairman of the Federal Reserve System, it may be useful briefly to replough the basic grounds for the Carter proposals. Mr. Burns, in his good-natured papal bull from the monetary Vatican on Constitution Avenue, pronounced that program "honest and reasonable" but probably unnecessary—or at best, premature—because "the economy is improving on its own." In almost a carbon copy of the assurances he offered 1 year ago on the 1976 economy, Mr. Burns predicts "that 1977 will be a good year for the Nation's economy."

But what the country needs now is not assurance that all will be well but insurance that things will indeed get better. And the Carter program addresses itself to the reality that economic recovery has fallen woefully short of any reasonable goals. Chapter and verse on this shortfall are contained in my opening statement before the House Ways and Means Committee last Friday which, with your permission, I would like to provide for the record this morning.

Representative BOLLING. Without objection it will be included in the record.

[The statement referred to follows:]

STATEMENT OF WALTER W. HELLER BEFORE THE WAYS AND MEANS COMMITTEE, U.S. HOUSE OF REPRESENTATIVES, FEBRUARY 4, 1977

Mr. Chairman and members of the committee: Let me take the opportunity that this distinguished Committee has afforded me to make and document three major points about President Carter's program to stimulate the economy. (Also, in response to the Chairman's request, I have prepared an "Addendum on the 'New-Jobs' Credit", which is attached to this statement.)

1. Given the poor performance of U.S. economic recovery in 1976 and the great distance the economy still has to go to achieve reasonable levels of employment and output, the 1977 portion of the Carter program, though well designed, is unduly modest in size:

The American economy has been under-achieving for several years. Recovery is far behind schedule. Compared with peak levels in 1973, industrial production has just barely exceeded its previous high. In real terms, business investment is down 12 percent consumer income is up only 4½ percent, and GNP, 3 percent. Contrast this with the average postwar performance after seven quarters of recovery: industrial production up 8 percent; business investment, up 5 percent; consumer income, up 8 percent; and GNP, up 8 percent, as compared to the pre-recession peaks.

In the past year, there has actually been some backsliding: unemployment is up by several hundred thousand; factory operating rates are about where they were a year ago, at roughly 80 percent of capacity; and the gap between actual and potential GNP still hovers around $150 billion (calculated at 5 percent unemployment), or about 8 percent of potential GNP. (Even the Ford Administration's more conservative calculation, converted to current dollars, shows a gap of $132 billion for 1976.)

The modesty of the Carter program for 1977, at $15.5 billion of stimulus, is quickly seen by comparing it with projected GNP of $1,875 billion. This stimulus of less than 1 percent contrasts sharply with the tax cut approved by your Committee in 1964. At $12 billion, it was close to 2 percent of that year's $636 billion GNP. By this time next year, our annual rate of output will have crossed the $2 trillion mark. In devising fiscal programs for an economy of that size, small is not beautiful.

Even though the economic lull ended as predicted towards the end of 1976, prospects for 1977, without fiscal stimulus, remained uninspiring: the prospect was for perhaps a 5 percent rate of expansion during the year, which would be boosted to about 6 percent by the Carter program,.

2. The setback to recovery from the staggering 1977 cold wave underscores the need for both speedy enactment and some expansion of the Carter program. If an $11.4 billion rebate was needed to step up recovery and create jobs before the cold wave hits us in the face and pocketbooks, an expansion of the rebate by perhaps $3 billion would now be in order:

Heating bills have been skyrocketing. Leaving out the West Coast where the weather is mild and taking account of the fact that about 80 percent of home heating costs are incurred in the three central winter months, one comes up with a base heating bill of $15 billion in the affected areas. On the modest assumption that the cold wave has boosted those bills by one-fifth, one comes up with a minimum impact of $3 billion. With bills in the Minnesota area running 60 percent above a year ago (partly because of a rate increase), and with many other parts of the country hit even harder, it seems not unreasonable to assume a one-third, or $5 billion, rise in heating costs for the heating season as a whole. Granted, this back-of-the-envelope calculation is modest compared to the far-out estimate of a $10 to $15 billion loss produced by at least one econometric model. But even at $3 to $5 billion of higher heating costs—plus some losses of consumer income by millions of workers furloughed or laid off temporarily because of energy shortages—the inroads into consumer buying power that would have gone into purchases of other goods and services is tantamount to cancelling about one-half of the impact of the $11.4 billion refundable rebate.

Some might say that the $5 or $6 billion does not disappear from the economic system. But let's see where it goes: most of it will flow into business coffers and be used to reduce debt, replenish gas and oil and coal inventories, and pay dividends and royalties into investors. These amounts will only partially and very slowly trickle back into the spending stream.

In short, the withering impact of the worst winter in modern times strenghtens the case for a quick and generous tax rebate. We are fortunate that we have a tax vehicle readily at hand to take much of the economic bite of the bitter winter weather.

3. Both the 1975 tax cut experience and the special circumstances prevailing in 1977 strongly support the conclusion that the tax rebate will quickly boost consumer spending:

The 1975 tax cut is very much a case in point. It included a large rebate and was initially enacted as a temporary cut. Yet, both the booster shot it gave the economy in the first year of recovery and the behavior of consumer saving provide convincing evidence that the tax cut proceeds rather quickly found their way into the spending stream.

True, consumers did—as they always tell the pollsters—at first route the proceeds into their bank accounts and installment debt reduction—the personal saving rate jumped from 6.6 percent in the first quarter of 1975 to 9.6 percent in the second quarter when the rebates were paid out. But having cleared the decks of some of their existing debt, they quickly incurred new debt. And the money temporarily parked in bank accounts soon came pouring out into the economic bloodstream. Evidence of this is provided by the performance of personal saving rates in 1975–76. Eliminating the quarterly wiggles and just looking at the saving rate for the seven quarters beginning with the second quarter of 1975 and ending with the fourth quarter of 1976, one finds that the saving rate dropped to 7.4 percent in the quarter immediately after the tax cut and kept on dropping in 1976. For the seven quarters as a whole, it averaged 7.2 percent.

Comparing this with the saving rate in the preceding five years, one finds that it is below the average of those years. The saving rates were 7.4 percent in 1970, 7.7 percent in 1971, 6.2 percent in 1972, 7.8 percent in 1973, and 7.3 percent in 1974. Thus, only in the boom durable goods year of 1972 did consumers save less than in the quarters after the 1975 tax cut was enacted.

As to the special circumstances of 1977: the drains on income from higher heating bills, weather-induced layoffs, and higher fruit and vegetable prices will pre-dispose consumers to spend their rebates quickly.

Add to this fact that, apart from the deep-freeze, the consumer is in an optimistic mood and ready to spend if she has the required income. As the Burns Roper year-end report put it:

"For the consumer to lead the country to recovery may require a one shot tax refund. One argument against such a refund has been that the consumer would squirrel it away and that it would thus not serve as the stimulant which it is intended to be. This might be true if the consumer were bearish. But ROPER REPORTS, both this issue and other recent issues, suggest that the consumer is rather bullish and would spend if he/she had the money."

ADDENDUM ON THE "NEW-JOBS CREDIT"

Chairman Ullman has asked for comments on the proposal for granting a "new-jobs credit" against employers' income taxes for workers added to their payrolls in 1977 and 1978.

1. As I understand it, the proposal might work something like this: Employers would be given a credit against income tax of 25 percent, but not more than $1,000, of the wages paid to employees added to their payrolls for example, in 1977 as compared with 1976 and in 1978 as compared with 1977. (It is not quite clear whether this would be only for employees with wages under $7,000 or $10,000 a year, as some have proposed, or whether—in the interests of avoiding complexity and "notch" problems—it would apply to all incremental hiring.)

2. The proposal has a good deal of appeal. It would be fairly simple, quick, and focussed sharply on jobs. It would not require elaborate bureaucratic machinery. And the $1,000 bonus to employers would lower the employer's price tag on low-pay workers enough to stimulate some additional hiring.

3. In appraising this proposal, one should probably view it less as a substitute for the across-the-board 4 percent payroll tax credit (or optional 2 percent add-on to the investment credit) and more as a substitute for a program for direct government payments or sharing in the costs of incremental private-sector jobs-and-training for the hard-core unemployed. One such program, for example, would require screening and identification of such hard-core or disadvantaged job seekers, issuance of vouchers that would entitle them to have the government pay a diminishing percentage of their wages for a 3-year period, and require that on-the-job training be provided as part of the bargain. The tax approach would presumably be open to all comers, would not attempt to screen or identify disadvantaged workers, and would not require on-the-job training.

4. Against this background, let me list the questions that the Ways and Means Committee might want to ask itself and its staff in a stop-and-look-and-listen probe of the job-credit proposal:

If the program is temporary and requires no investment in job training, won't there be an incentive to drop workers once the tax bonus runs out? And if it is made permanent, wouldn't it be perverse or "pro-cyclical" in its fiscal policy impact, lowering tax liabilities in a rising economy and raising them in a falling economy?

Won't it, to some extent, inhibit investment in labor-saving machinery and equipment that would increase productivity but reduce jobs?

Won't it worsen the positions of industries and regions (like New England) that are expanding slowly or even contracting—and have high unemployment—relative to industries and regions (for example, the Sun Belt) that are already vigorously expanding and have low unemployment? Isn't there a considerable element of "to him who hath shall be given"? A direct jobs program could avoid much of this by giving more emphasis to the high-unemployment areas.

Although tax credits have the seeming advantage of being self-administering, won't the IRS have a burdensome new job of checking the job rolls of millions of business establishments? (Perhaps working from the unemployment compensation base of $4200 would simplify this administrative task, but would reward the hiring of many part-time workers.)

Even with the required rack-up of tax expenditures in the Budget each year, won't this be a kind of back-door financing, the cost of which is none too visible to the public?

In spite of greater bureaucratic machinery and red tape, would not the net impact of a selective program of direct payments for hiring and training of carefully screened job seekers among the hard-core or structurally unemployed come closer to achieving the objective we seek? It would cost more to administer, but the more precise targeting could more than make up for this cost. In the last analysis, it might well provide a bigger bang for the buck. Since the tax credit approach would not differentiate among those hired (except perhaps with respect to the level of pay), would it not be granting a subsidy, for example, for the hiring of illegal aliens?

If it appears that I have put these questions in a way that suggests the answers, I plead guilty. But I should also underscore that, having had only a day or two to reflect on this proposal, I am still in the stage of having more troubling questions than assured answers. If the tax credit for job add-ons is the only significant program we are likely to get in the next year or so to provide government assistance for private-sector jobs, I would have to view it differently than if it is reasonable to expect—as I hope it is—that a more pointed program avoiding some of the possible pitfalls of the tax approach will not only be developed and proposed but will have a good chance of adoption.

Mr. Heller. The essence of the cause for action today is threefold:

Recovery is far behind schedule. As compared with prerecession peaks in 1973, consumer income and GNP are only up about half as far in the average postwar recovery; industrial production, usually up at 8 percent at this stage of recovery, has just barely exceeded its previous high; and business investment, usually up 5 percent, is down 12 percent. All references are in real terms, corrected for inflation.

As a result of sluggish recovery, the number of jobless workers rose during 1976; factory operating rates were stuck at about 80 percent of capacity; and the gap between actual and potential GNP—at 5 percent unemployment—remains around $150 billion, or 8 percent of potential GNP. In other words, after 20 months of recovery, unemployment and slack are still at levels more typical of the bottom of previous postwar recessions.

The reason I emphasize that is that there is so much emphasis on each little wiggle in the statistics from month-to-month instead of putting the emphasis where it belongs, namely, on the tremendous shortfall or underachievement or underperformance of the economy. We are far behind any kind of reasonable goals and recovery rates.

The prospects for 1977, without stimulus, were for expansion at a 4 percent to 5 percent rate—and it is worth underscoring that the Carter proposals were predicated on that kind of advance, not on a "fizzling out" of recovery or the onset of recession. President Carter rightfully deemed that pace of expansion inadequate.

As spelled out in the Ways and Means statement, the bad case of economic frostbite the country is suffering today actually calls for a larger tax rebate than Mr. Carter has proposed. On the basis of a conservative calculation of the cost of the cold wave, a modest expansion of perhaps $3 billion would be in order.

If the Congress desires to provide somewhat greater relief to the lowest income groups, who have been hardest hit by both inflation and the frigid weather, it might consider a cutoff of the rebate for upper bracket taxpayers. If the $50 refundable credit—I know that Charlie Schultze and the administration would like to keep it across the board and simple, but as Arthur Burns said the other day, it seemed strange for people in the upper brackets to get their rebate. If Congress wanted to save a little bit more for distribution to lower income groups, that is, raise the per capita, it could cut it off at $25,000, giving you $818 million of saving; if it were cut off at $30,000, it would free $704 million of savings that could be redistributed.

Although I have suggested the $3 billion expansion of the rebate as an antidote to the economic bite of the cold wave—and we are fortunate to have a tax vehicle already in motion for this purpose—I should make clear that I agree with many other observers that the basic condition of the economy would also accommodate an expansion of the Carter program. Given the overabundance of idle resources, a somewhat larger program would pay off nicely in added jobs and output with virtually no risk of additional inflation.

I am sure this committee is aware that Paul McCracken has opted for a $24 billion program and the business group headed by Reginald Jones, $23 billion and, of course, some people have been advocating a $30 billion program. Again, being more conservative. I think we could more readily make use of a $20 billion program for 1977 and wait to see about the size of the 1978 program.

Beyond questions about the underlying need for the program and its size are two others that have been the source of much debate: (1) the one-shot versus permanent tax cut approach; and (2) the balance between tax cuts and jobs programs. The two questions are obviously interrelated.

In the argument for converting the rebate into permanent cuts, one allegation is that a temporary tax cut will be saved while a permanent cut will be spent. But as the appended statement brings out, this ignores the evidence that the personal saving rate in the quarters following the tax cut actually dropped below the average rate before the tax cut. Specifically, even counting the 9.6 percent saving rate in the second quarter of 1975, the overall saving rate for the seven quarters since the tax cut comes to only 7.2 percent. This compares with savings rates of 7.3 percent in 1974, 7.8 percent in 1973, 6.2 percent in 1972, 7.7 percent in 1971, and 7.4 percent in 1970. Thus, in the quarters after the 1975 tax cut was enacted, consumers saved less than in any of the preceding 5 years except the durable goods boom year of 1972.

But, some will ask, how does it square with what consumers tell pollsters, namely, that they will put most of their tax rebate into savings or debt repayment? It squares very well, for one quarter. But as the savings data make clear, the money parked in bank accounts is soon drawn out to finance consumer purchases. And as the decks are cleared of some old consumer debt, new debts are quickly incurred. Add to this the special pressures on consumers in 1977—higher heating bills, weather-induced layoffs, and higher fruit and vegetable prices—and the likelihood that rebates will simply boost saving is remote indeed.

A second assertion by permanent tax cut advocates is that the force of one-time cash rebates will be spent so quickly that it will leave the economy in the lurch later on. It is to be hoped that opponents of the tax rebate will see the inconsistency between this argument and the preceding one, just as it is inconsistent to argue that the tax rebate will be (a) saved, and (b) inflationary. But this assertion ignores (a) the evidence that the impact of the rebate will be felt for many months, and (b) the careful design of the Carter program to phase in expanding jobs and public works programs as the direct stimulus of the rebate phases out.

A third argument is that we must cut back Federal spending and that the permanent tax cuts will contribute to this worthy end. But how worthy is it? Quite apart from differing sets of value preferences, three important facts are worth bearing in mind as the Congress acts on the proposed jobs and public works programs:

One, as Paul McCracken recently noted in The Wall Street Journal in arguing for stepped-up public works:

> The volume of public construction is now, in real terms, about 25 percent lower than a decade ago—in an economy that, in real terms, is 30 percent larger. Public construction is now so low, in fact, that the real value of public capital is probably not being maintained.

Two, as Charles Schultz brought out in his recent Brookings study of Federal spending: Federal baseline expenditures in current dollars have risen from 18.2 percent of GNP in 1955–60 to 20.1 percent in 1975–77; however, in constant dollars—that is, corrected for inflation as it affected different sectors of the economy—there has been a drop from 18.2 percent to 15.8 percent of GNP.

Three, the Carter program pointedly leaves options open on future spending or tax cuts. The rebate itself preempts no future tax revenues. The public works program will run its course. The specific jobs programs and counterycyclical revenue sharing will phase out as unemployment drops.

Let me turn, finally, to those whose values lead them to believe—as I do—that expenditure restraint has been carried too far. In the context of the Carter fiscal program, three observations may be in order:

First, being for a sizable tax rebate is not at all tantamount to being against more adequate spending for social programs. Indeed, apart from its simplicity and speed, the tax rebate has the great advantage of keeping those options open.

Second, perhaps the greatest enemy of adequate Federal funding of social programs is the widespread impression that they have been costly, cumbersome, and inefficient in administration. Even if this picture is overdrawn, it would gain new support from any crash attempt to put huge public works or jobs programs into effect overnight. To avoid confusion, inefficiency, and failures in delivery under these programs, the Carter approach is one of all deliberate speed. Some modest add-ons here and there may be feasible. But a huge forced-draft program might well be self-defeating.

Third, this is in no sense an argument against the substance of the programs in question. It is simply a recognition that while no time should be lost in putting them in place, their impact will be mainly in the second and third rounds of the battle against unemployment. But the only fiscal device that can put spendable funds quickly into the hands of consumers remains the tax rebate. It is a case of "first things first." Apart from its simplicity and speed, the tax rebate has the great advantage of keeping these options open.

I underscore that, because both in appearing before the Ways and Means Committee the other day and in trying to keep track of what is going on down here in the Congress, I find a good deal of skepticism and hostility to the tax rebate, yet in terms of its merits and the fact it is the only thing one can do promptly; the fact that it does not get in the way of anything else, it leaves options open; the fact that it will be spent and stimulate a laggard economy; the fact that it can be adapted to help overcome, the economic frostbite the economy has suffered, in the light of all those considerations, I find this skepticism and opposition very hard to understand.

Representative BOLLING. I had found it hard to understand until I finally figured out what it was. Apparently a relatively large number of people's constituents—I don't have this experience but others do—make fun of it. It has arrived at the consciousness of enough politicians that they begin to wonder about its political effect. It is a very curious response, but I am pretty sure it comes from personal contacts from people who say, "why the hell should I get it, or why should anybody get 50 bucks?"

I think it is really political because it certainly did not occur before this time.

Mr. HELLER. If I may offer one quick comment, if my colleagues will permit, I have run into this argument for so long. I remember Martha Griffiths of this committee some years ago in what became the 1964 tax cut saying to me this is such a small amount per person, this $12 billion tax cut.

I guess people just don't think aggregately, the fact that it is $50 per person—it is almost $12 billion for the economy. So what you are citing is a pretty standard reaction.

Representative BOLLING. You know us too well to know we don't count votes one-by-one.

STATEMENT OF HENRY KAUFMAN, PARTNER AND MEMBER OF THE EXECUTIVE COMMITTEE, SALOMON BROS., NEW YORK, N.Y.

Mr. KAUFMAN. My name is Henry Kaufman, general partner and member of the executive committee of the investment banking firm of Salomon Bros., headquartered in New York City. I also serve as the firm's chief economist and head of its bond market research department. I appreciate this opportunity to express my views on the American economy and the financial markets.

In appraising the employment and business prospects for 1977, I believe that the Government now has an unusual opportunity to steer the economy on a path of long expansion. Such opportunities do not present themselves often. They are usually available during a recession or perhaps the first year of business recovery but rarely, if ever, in the third year of expansion, which we are about to begin.

Oftentimes, when the third year of business recovery has been reached, the economic and financial arteries have hardened so much that it is too late for the Government to put in place policies that will assure steady and sustainable economic expansion.

However, this year is different and thus can work to our national advantage if we are willing to understand and deal with the uniqueness and complexities of the current situation.

It is incorrect, and possibly dangerous, to adopt a purely cyclical perspective in viewing the American economy or, for that matter, initiating national policies. Too many atypical developments have transpired in recent years which have shed doubts on the use of techniques that overlay one period upon another as a basis for finding national policy prescriptions.

There are, admittedly, broad similarities in comparing this recent recession and present recovery with previous ones. The most obvious, which we all know, is real gross national product, which has increased at an annual rate of 5.8 percent since the trough in economic activity in April 1975. This is slightly better than in most earlier comparable periods of economic growth.

But, this very broad comparison should not be accepted as the criterion for establishing anticyclical national policies. Too many other important aspects of our economy have not followed the direction that the past has typified in the transition from recession to recovery and on to the first 2 years of economic growth. Let us look at some of these dissimilarities in the economy during two time periods— the 1974–75 recession and the initial recovery period—and let us also examine certain key developments in the financial markets.

During the 1974–75 recession, there were these aspects which were unlike those of previous typical cycles:

The rate of inflation stayed unusually high. Wholesale commodity prices averaged 14.4 percent as compared with 14.9 percent for the last year of the preceding business expansion.

Real personal income actually contracted. Typically, it increases slightly, or remains flat, during business recessions.

Housing, which usually begins to rise during the second half of a recession, continued to fall and only bottomed out just before the start of the recovery.

Outlays for plant and equipment by business and investments in inventories continued to increase in nominal dollars, delaying the restoration of liquidity to business.

Interest rates, instead of declining during the recession, continued to rise and reached new peaks.

Extraordinary credit stringencies prevailed, including prominent bankruptcies and the strong preference for high quality investments by many lenders and investors.

Unit labor costs rose dramatically at a time when the number of unemployed was increasing.

If we turn now to atypical developments since the recovery began in April 1975. we will see further dissimilarities which will suggest that the approach of "What did we do during the last business cycle?" is not only inappropriate but perhaps inherently harmful. For example, since April 1975:

Real nonresidential fixed investments have proceeded at a snail's pace. This sector has grown only at a seasonally adjusted annual rate of 1.7 percent which is shown in table 1.

Multiunit and commercial building activity has remained subnormal.

Business inventories have fluctuated widely instead of expanding steadily.

The unemployment rate has declined only slightly since the start of the recovery although the number of people employed has increased.

The rate of capacity utilization of manufacturing businesses is only 80.5 percent. While this indicator has increased about 10 percentage points from its cyclical low, the current utilization rate is well below the levels that prevailed during comparable earlier periods of economic expansion.

Finally, the progress made in reducing inflation cannot be viewed with equanimity. Wholesale commodity prices still rose at an annual rate average of 8.4 in the fourth quarter of last year, the seventh quarter of economic expansion.

The events in the financial markets during the past 2 years of economic recovery were also not typical of the so-called conventional business expansions. In the private sector, an overriding consideration for investors, consumers and businesses was remedying their acute liquidity squeeze. Moreover, interest rates fell gradually and irregularly and the ability of medium-quality borrowers to attract funds did not improve until quite recently.

Besides the challenges which these dissimilarities pose to national economic policy decisions, our Government is also challenged by other difficult noncyclical developments. The energy problem is not only inhibiting us as has been dramatically demonstrated again by the hardships imposed by this winter's cold wave, but it also has adversely affected the free industrial world and oil-consuming underdeveloped nations. Furthermore, issues concerning the quality, in addition to the quantity, of economic growth complicate the economic scene.

Specifically, where are the opportunities and what are the challenges which confront us in 1977?

Our opportunities lie in the fundamental economic fact that we have substantial unused resources in both employment and physical resources of business and that there are many needs to be satisfied both here and abroad. These opportunities are presently enhanced by an improved financial backdrop which can provide stronger underpinnings to the economy than has been the case in several years.

We should maximize the strengthening of the economic underpinning in strategy formulation. We are fortunate now that many of the financial impediments of economic expansion that prevailed when the economic expansion began in the spring of 1975 or were evident even at the start of 1976 have been substantially alleviated. Business corporations have strengthened their balance sheets through huge cash inflows, a massive refunding of short-term debt and prudent management of real assets. Some State and local governments, which had been under severe financing constraints, are now able to finance again, especially in the bond market.

Consumers have increased appreciably their savings from current income. This, in turn, has improved markedly the liquidity position of major financial institutions. Moreover, the real net wealth of consumers has recovered substantially. Finally, the interest rate structure as 1977 begins is far more conducive to economic expansion than it has been anytime since 1972.

The challenges today are in the areas of the need to develop governmental programs that will enhance consumer confidence, sustain the recovery in housing and spur lagging business investment. Most important of all, such programs must provide adequate assurance that we will not repeat in national policymaking the mistakes of the past decade. Rather these programs should be directed toward moving the economy forward on a sustainable trajectory.

But, unfortunately, the new fiscal stimulus proposals do not provide such assurances. Setting aside for a moment the retarding influences on business activity of the winter weather, the economy in recent months has improved considerably from the temporary lull of last fall.

Consequently, the fiscal stimulus will occur belatedly and without full recognition of the renewed forces of economic expansion. Furthermore, this stimulus is likely to give the economy a somewhat larger lift than is now generally expected. One principal reason for this is that many of the beneficiaries of this stimulus are better prepared financially than they were in 1975, when the full force of tax reductions was partially deflected by their need to restore their financial situation. While some fiscal stimulus is warranted, the administration's proposals contain no satisfactory devices for slowing, expanding or changing its composition as economic developments change. This applies particularly to that portion of the program which is scheduled for fiscal 1978. The magnitude of the proposed fiscal stimulus also has raised some apprehensions about our ability to finance the accompanying large Treasury budget deficit without placing new pressures on financial markets. As evidence, witness the recent price declines in both the stock and bond markets.

However, the major shortcoming of the administration's program is not so much its content as it is a critical omission. The program should have been accompanied by an anti-inflationary agenda.

Why is there an urgent need for an anti-inflation program now? Can it not be argued that this need is overstated because the slack in the economy is bound to dampen inflationary pressures? This view and policy approach have led us into trouble several times since World War II, and, within the past decade, have inflicted serious economic strains on a number of occasions.

The fact is that the fight against inflation must be the continuous business of government. When an economic boom is at full throttle, it is too late to subdue inflation without resorting to painful economic measures. The experiences of the last few years have amply documented this. The seeds of inflation and therefore recessions are sown by our actions in periods of early economic expansion. Once the economic and financial arteries have hardened, it is virtually impossible to change radically the future course of events.

In this regard, it is a fallacy to conclude that we can compartmentalize economic time periods as though they were separate entities, and, therefore, to think we can choose suitable national policies for each.

I have already noted some of the atypical events that prevailed during the last recessions and thus far in this economic expansion. National policies cannot start at ground zero. They must recognize the problems inherited from the past. And in this light, it is crucial that steps are taken to reduce inflation further this year. If we do not, a longer lasting stable economic expansion will again elude us.

Our economy is not as flexible as it used to be. There are now wage and price rigidities which have been compounded by the flareup in oil prices as well as the supersensitivity of Americans to adverse inflationary news. For these reasons, the government must act now to legislate anti-inflationary measures. Only the consistent failure of expectations of renewed inflation to materialize will ease our feeling about the destabilizing events of the recent past and increase our confidence in the efficacy of governmental action in the future.

If an effective anti-inflation program is not legislated this year the economic recovery will not abort by yearend, but its limited duration will become readily visible. Even in 1977, however, we will run the risk of generating new frictions that will prevent achieving our economic objectives. This is because a rise in inflation will increase interest rates and endanger several vital economic sectors including housing and plant and equipment expenditures by business. Moreover, it will complicate the financing of the Federal budget deficit.

I would like to make an important distinction here between an interest rate outlook based solely on business considerations and one which would reflect rising inflationary expectations. Concerning the former, some increase in interest rates this year is, of course, unavoidable but it should be confined largely to the short-term interest rate sector. The reason simply is that there is likely to be an enlarged demand for short-term credit, reflecting the step-up in working capital requirements of business, consumer credit and borrowing requirements of the Federal Government.

Concurrently, liquidity building by business, financial institutions and consumers, which helped push short-term interest rates down last year, will diminish and even stop in some sectors.

Can we have some increases in short-term interest rates without additional substantial upward pressure on the long market? I think that this is possible under certain conditions.

History certainly shows that both short and long-term interest rates do not always move in the same direction. For example, during this century to date, prime long corporate bond yields moved in the same direction as did short commercial paper rates during 58 years and moved in the opposite direction during 19 years.

In addition, some increase in short-term interest rates and a trendless pattern for long-term interest rates ought to be feasible considering the current levels of short- and long-term interest rates. The yield differential between short- and long-term interest rates has been extraordinarily large ever since the economic expansion began in April 1975.

For example, the yield differential between 3-month Treasury bills and the longest dated Government issue averaged 226 basis points in favor of long bonds in 1975, and 283 basis points in 1976.

It is now about 290 points. These wide differentials reflect among other things the strong preference for liquidity, the huge surge in long financing needs by business, and inflationary expectations. Now liquidity has been substantially improved, and long-term financing requirements of business ought to abate for the time being. But, inflationary expectations hang in fragile balance.

The need to shackle inflation this year is necessary if the huge U.S. Treasury deficit is to be financed smoothly and not cause disruptions for the economy and financial markets. Unfortunately, the impact of financing Treasury deficits on the markets has been oversimplified by the use of the term "crowding out," which masks a variety of influences that deserve to be evaluated and recognized.

In its simplest sense, "crowding out" means the denial of credit to someone in the private sector, be it business, consumer or State and local governments. This denial could be a complete cut-off of funds or a redirection of financing alternatives, for example, from long to short-term borrowing or from open market financing to bank borrowing.

It should also be recognized that huge Treasury borrowings influence significantly the levels and the structure of interest rates and limit the flexibility of monetary policy. It cannot be refuted that interest rates would have been somewhat lower during the past 2 years if the Treasury deficit had not been as large.

Moreover, the composition of Treasury financing last year had a strong impact on the maturity structure of interest ranges. It retarded the decline of intermediate and long-term interest rates and had much less effect on short-term interest rates. This tradeoff between the level of interest rates and the magnitude of the Treasury deficit involves difficult political and economic choices, to be sure. I do not mean to suggest that the budget deficits were entirely unnecessary.

The financial markets do not have as much leeway to finance a large budgetary deficit this year as they did in 1975 when the previous fiscal stimulus was introduced. I have tried to illustrate this point in table 2, which summarizes major annual net demands for credit from 1973 through 1977.

When the Treasury and the various Federal credit agencies borrowed net $84 billion from the private sector in 1975, long-term borrowing by the private sector (consisting of mortgages, corporate bonds, municipal bonds, and foreign bonds) totalled $93 billion while short-term private borrowers actually repaid net $6 billion.

This year, however, when the Treasury and agency demands may total $77 billion and perhaps more, long private demands will reach an estimated $121 billion and short-term private demands instead of declining will increase by $54 billion.

This year, in particular, the Treasury will be competing much more with the housing sector than it did in 1975. Therefore, considering the limited tolerances in the credit markets this year, legislating merely the fiscal stimulus without tackling inflation head on is likely to be self-defeating.

It should also be recognized that benign neglect of new inflationary developments will put monetary policy in an untenable position. Even if this year's inflation rate is held at last year's levels, it is likely to result in large money supply increases. Higher rates of inflation, of course would drive up the demand for money still further.

In looking back at the performance of monetary policy since the start of the current business expansion, it is probably true that the monetary authorities tightened too quickly following the money supply explosion in June 1975 and April 1976. I doubt that this experience should hold necessarily as a lesson for the months immediately ahead.

In those previous periods, the desire by the private sector to restore financial balance was strong, which amplified the impact of the Fed's tightening. Now, this need has diminished. We need not necessarily be full-fledged monetarists to know that the consequences of months of large increases in money supply are difficult to undo. It is far easier to avoid the risk of encouraging new inflationary expectations as the result of generating large money supply increases.

From my vantage point, I can only tell you that both the stock and bond markets would decline if money supply is allowed to rise sharply for an extended period. It would heighten fears of a delayed outburst of inflation and of belated tightening of money market conditions by the Federal Reserve to bring monetary expansion again into acceptable ranges.

These adverse developments, however, need not happen. We can have high rates of real economic growth this year provided that Congress legislates an effective anti-inflation program. Such action would give formal recognition to the fact that sustainable growth can be achieved only against a back-drop of reasonable price stability. It would create confidence in the durability of the economic expansion and business and consumers would increase spending. The latter would be encouraged by expectations of new gains in real income. The fear of business of large future increases in external financing needs and inadequate profits to pay for capital outlays would be reduced.

One thing is clear—the proposed economic recovery program of the administration does not address itself directly to the inflationary problem. It assumes that prices and costs will behave because today's price rises are supposed to be the result of past conditions. The concept of "momentum inflation" is just the type of compartmentalization of economic time periods that pushed the economy into serious problems in the past. There is nothing new in this at all.

What should an anti-inflation program contain? Let me offer just a few suggestions. It should, for example, go far beyond the cyclical relief for the unemployed that is proposed by the administration. The need is to move up the disadvantaged from the end of the line to a point where they have equal opportunity. In particular, we must reduce the size of future generations of disadvantaged. No large, broadly based stimulative policy can achieve this objective. Eliminating future generations of disadvantaged requires policies and initiatives designed to span many business cycles.

The program must begin by intensive academic and vocational training of the very young in the ghettos. This training should require longer school hours, a higher ratio of skilled teachers to pupils and rigorous testing of progress and accomplishments. Within time, the students of this training will be prepared to enter the economic mainstream and thus enhance productivity generally.

Another feature of an effective anti-inflation agenda should be gradual dismantling of the disincentives to work. Programs initially designed to alleviate temporary hardships have given rise to perpetuating welfare classes and the loss of incentives for self-achievement.

Regarding capital markets, the growth of risk capital has been retarded by the recent high rates of inflation and inequities in the tax structure, such as the double tax on dividends. In addition, the combination of high rates of inflation and a progressive tax structure has held back gains in real earnings.

An anti-inflation program should also contain measures that will slow or reduce costs in a variety of sectors. Import restrictions should be reduced or lifted whenever domestic producers benefit unduly or economic excesses manifest themselves. Government regulations should, on balance, favor rather than restrict market competition in regulated industries. Congress should examine intensively the network of Government agencies that supervise our many regulated industries. Too often, priorities have been established favoring servicing needs without adequate thought about their costs. The Government should support bipartisan nonpolitical machinery that will enforce competitive wage and price practices. The rising medical and dental costs should be attacked, among other ways, by Government subsidies that will finance more medical and dental schools and the education of their students in order to sharply expand the supply of doctors and dentists.

The bad weather lately confirms again the urgent need for a coherent energy program. There should be incentives for energy conservation and for the development of new supplies. Indeed, the rising cost of energy makes fighting inflation on other fronts even more important.

Once and for all, our Government should clearly state that mandatory wage and price controls are not an acceptable stabilization approach in peacetime.

As I noted at the start of my remarks, our Government has a rare opportunity this year. Do not act merely to provide a cyclical lift to the economy. Instead, strike a blow in favor of a more enduring expansion by legislating anti-inflation measures in conjunction with the new fiscal stimulus.

[The tables referred to in Mr. Kaufman's statement follow:]

TABLE 1.—SELECTED DATA ON ECONOMIC EXPANSIONS

Expansion period	Average quarterly percentage changes in first 7 quarters[1]: Real GNP	GNP deflator	Real nonresidential fixed investment	Rate of capacity utilization: Trough	7 quarters later	Unemployment rate: Trough	7 quarters later
1975–76	5.8	5.4	1.7	70.9	80.5	8.1	8.0
1970–72	5.5	4.4	5.5	76.3	83.4	5.9	5.6
1961–62	5.2	1.8	2.9	73.8	81.6	6.8	5.5
1958–60	6.1	2.3	7.9	72.4	84.5	7.4	5.1
1954–56	5.4	2.2	9.7	79.7	87.6	5.8	4.0

[1] At annual rates.

TABLE 2.—CREDIT DEMANDS, BY TYPE

	Annual net increases in amounts outstanding (dollars in billions): 1971	1972	1973	1974	1975	1976e	1977p
Privately held mortgages	44.3	68.8	68.7	42.8	38.5	61.3	69.5
Corporate bonds	24.7	18.9	13.5	27.5	32.7	27.6	24.1
Domestically held foreign bonds	0.9	1.0	1.0	2.2	6.3	9.3	10.4
State and local debt	21.7	12.8	14.1	14.5	15.7	13.7	17.0
Subtotal long-term non-Federal	91.6	101.5	97.3	87.0	39.2	111.9	121.0
Subtotal short-term private[1]	24.6	53.0	73.8	63.1	−6.1	30.5	54.0
Subtotal privately held Federal debt	21.7	24.2	19.2	28.1	83.5	74.9	77.0
Total net demand	137.9	178.7	190.3	178.2	170.6	217.3	252.0

[1] Consists of business loans, security loans, agricultural loans, consumer and other personal loans and open market paper issuance.

Representative BOLLING. Thank you.
Mr. Modigliani.

STATEMENT OF FRANCO MODIGLIANI, PROFESSOR OF ECONOMICS AND FINANCE, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. MODIGLIANI. Mr. Chairman, it is a pleasure to again be here with you today at the dawn of a new administration and to try to give you my views on both the economic outlook and the policies which are now being considered.

Let me say that the basis of my testimony today will be that I agree with the administration's view of the need for further stimuli, that I have sympathy with the thrust of the program but have serious reservations about the details of the program, and I would like to suggest that Congress might give attention to quite different approaches to the problem of stimulus.

First, regarding the economic outlook in the present situation, it has been interesting that we have been going through a hot and cold shower about the state of business.

We have been going from one day to the next with views that the economy was recovering rapidly to views that it was in the one day doldrums, economy was going up and then down the next day.

I have kept my cool throughout these episodes, for one reason I have told this committee before: The American public and the Congress is paying much too much attention to the wiggles of our statistical series.

Let me cite the recent important experience of the unemployment series. We had quite loud shouting in the halls of Congress when Mr. Shiskin announced the unemployment rate fell to a low of 7.3, by one-half of 1 percent in 1 month and some people have immediately inferred that actually the economy is doing very well and there is not really much slack.

I had known about the sharp decline in January for at least 8 months. I knew it was coming and I had bets and won money on this. As I told the committee before, the unemployment series is seriously off because the seasonal adjustments are quite wrong.

In my view, what happened this year is that unemployment fell rather steadily, though quite moderately from the beginning. It fell perhaps three-tenths of one percent in the first half of the year and another 10 in the last half of the year. Few, if any, of the ups and downs of the official series had a real counterpart. There was no 8 percent in November or 7.8 in December, and conversely, the 7.3 percent unemployment in January understates the truth appreciably. The only reliable information is that the average for the year is around 7.7.

The reason I expected the sharp decline in January is that last year from December to January we had exactly the same decline of one-half to 1 percent, at a time when nothing was happening in the economy.

Any knowledgeable person knows that unemployment does not make jumps of that kind—and if it did, one should pay little attention to it.

My view is that in effect all these vagaries reflect a defective seasonal adjustment.

I do believe Congress should take some interest in the shortcomings of the unemployment statistics. Unemployment is not only an important indicator, but now it is also used to determine the so-called anticyclical sharing with the State and local governments. So, things do directly depend on it and I feel it is time some effort be made to improve the seasonal adjustments.

Let me add that I have strong reasons to believe that the currently used seasonal adjustment tends to produce an artificial decline in unemployment until May, and an artificial rise from May until November or December.

If you are in an election year, such distortion can cost someone the election, as I have suggested more than once.

Senator HUMPHREY. So you are saying thank God we don't have an election this year.

Mr. MODIGLIANI. I like the way the election came out, but feel that they should not be swayed by wrong information. It seems to me as you look at the situation of last year it is quite clear that, leaving out the misleading wiggles, what happened was a rather vigorous first quarter due to inventory movements, followed by a rate of growth which would have been satisfactory if we had been at full employment, but was absolutely unsatisfactory when we started out with a 7½ to 8 percent unemployment rate.

Some of the fluctuations have been due to inventory and the final demand has been slow, gradually moving up but the growth in the last quarter was only in the order of 4½ percent.

Now, these figures are, I think, interesting as we look ahead because I would agree, although I don't have any forecasts of my own—I rely on others'—with what seems to be a substantial consensus that, in the absence of any stimulus package, next year's growth would not be much higher than it has been in the last two quarters, when the increase in final demand has been between four and a half to five.

Now, I submit that that growth is just inadequate for next year as it was inadequate for last year. We still have unemployment and while we don't know reliably what it is on any particular date, we know that it was 7.7 on the average this year and can estimate it at somewhere in the order of 7.5 percent at the present time. That means we have at least 1½ percentage points of unemployment which is pure waste in the sense that one could not make a reasonable case that there would be a danger of reviving inflation as long as unemployment is above 6 percent. Even being conservative, as Mr. Heller has said before, I don't think anybody can argue that as long as unemployment is above six percent anything can happen to systematically increase inflation. Inflation can come down either fast or slow but must come down as long as unemployment is as high as that. So, we have 150 basis points, 1.5 percent of excess unemployment.

What kind of employment outlook do we need? Here one gets involved with many uncertainties. One can say that with the growth of the labor force set around 2.5 percent, perhaps a little less, and productivity growth which can be set around 3 percent, perhaps a little less but not much, it would take a growth of output of about 5.5 percent just to keep unemployment from increasing.

If you are to reduce unemployment by 1½ percent, you need around 7 percent growth. That, I think, is essentially the kind of target for growth we might aim for. However, we probably ought to be a little conservative and aim for something a little less than that so that if things turn out on the high side, we will not overshoot the unemployment target, though if we should exceed that target and unemployment went to say 5.8, it would still be in an allowable range. But that seems to be the nature of the broad target we should have not far from 7 percent growth.

Now, let us see at this point what is the administration program. What is the general policy program?

First of all, the administration target is considerably below that as you have seen from Mr. Schultze' and other members of the administration's statements. They speak of about 4¾ without stimulus, and the stimulus package is supposed to add 1¼ percent bringing it up to 5¾ percent from the fourth quarter of 1976 to the fourth quarter of 1977. I think that is, on the whole, an inadequate tagret. So, my first point is that we need a higher target than the administration proposes.

The next question is how does the administration propose to achieve that target and what seems to be the chances of success.

Let me add at this point something that was inspired by Mr. Heller's statement.

I believe we need this kind of target but I do not agree with him that we need to do anything special or significant for the cold wave. To approach relief of the cold wave by giving everybody $10 or $5 or whatever it may be, just strikes me as preposterous. If people are cold in Buffalo, we ought to give them something—all the help we can. I see little reason why we should give people in southern California with very warm and pleasant weather any relief.

As in many other cases—and I would agree with Mr. Kaufman here—we should be much more prepared to target policies to specific problems rather than using this broad one-shot approach. I think the cold wave does not require any action except specific relief to the people who suffer.

I think the effect on demand and supply is zero. It has reduced employment and demand and it has also reduced output. The two things go together and there will be more employment later to make up for some of the losses.

I don't think there is any net effect that needs to be offset, at least not a significant one.

Let me come to the policies and first to monetary policy. I notice that the Council in its report skirts very nicely around this issue. The targets of the Federal Reserve may be all right if everything works out well.

Maybe 10 percent will do for m_2 but it is very unlikely. But no place do you see any statement where the target may have to be raised.

If, in fact, 10 percent is an adequate ceiling, then I agree with Mr. Kaufman that it is undesirable to be out of control. If one knows that 10 is inadequate, they do something in advance. From the psychological point of view it is much healthier to raise the target than to exceed it.

It seems to me that the policy announced by the chairman is inadequate, particularly if he does not want fiscal stimulus. There is a very general agreement about prices rising at around 5 to 6 percent. Even the CEA report foresees a rise of 5 to 6 percent and between 11 and 12 percent growth of money income. Such an increase is likely to be accommodated by or consistent with, a 10-percent growth of m_2.

It seems to me this is an issue that Congress, in its supervision of the Federal Reserve, ought to tackle with Mr. Burns. Again, ask him what kind of growth in income do you think you are going to be supporting with a 10-percent growth of m_2. What is your target? Is it 10 percent? If so, what is your expectation of inflation?

I would very much like to know if Mr. Burns thinks the change in velocity is such that he can accommodate a real growth of at least 5 to 6 percent and a money growth of about 11 or 12.

The reason I talk about monetary policy first is this: When we have a situation in which we have a large amount of excess unemployment and capacity, you can always go back to the Keynesian view and say that investments are too low relative to national saving and that there is an imbalance between investment, high employment and national saving. The way to resolve the imbalance is either to increase investment or reduce saving, with national saving reduced by Government deficit. A consensus of opinion reflects the important need for investment. So rather than reducing savings, what we should do is to encourage investment. That means, to begin with, a very easy, monetary policy. I cannot understand why we keep hearing from conservatives at the same time that we must encourage investment but we must not have an easing of credit conditions. Instead investment should be increased by increasing the return on investment, by so-called give-aways.

However, I think that method is completely wrong, especially since in my view many of these measures in the long run only have the effect of increasing interest rates.

So, it seems to me, again, that a more expansive monetary policy is not only consistent with my target but also with the target of getting the expansion first by way of high investment—housing included but not only housing.

Let me come next to the fiscal package. The administration proposal is a package of $31 billion divided into 2 years.

My first objection to the administration program is that it is just too scattered into many little rivulets. To begin with it is divided into two parts, half this year and half next year. I agree with Mr. Kaufman that that is not very sensible. If we succeed in getting the economy going and reach our 6 percent target for unemployment, then we don't need a stimulus next year but rather restraint.

The next question is that the $15 billion, which is less than 1 percent of GNP, is expected to produce a stimulus, an addition to GNP of 1¼ percent, which roughly means over $20 billion. I do not believe that the package of the administration would produce this effect this year. It will produce effects sometimes, yes, perhaps 10 years from now, but the effect we want is now. What we need is a program that is targeted in turn to produce effects now.

My greatest reservation in this connection applies, of course, to the tax rebate. Let me say a couple of words about one-shot giveaways and on whether they are likely to be saved.

My own research bears some responsibility for calling attention to the fact that transitory variations in income may be largely absorbed by saving. In the past, however, I have not been a strong believer that this proposition necessarily applies to taxes. I have been neutral and people who have used my arguments have even accused me of not understanding my own work.

After hearing various statements about the 1975 tax, I took the trouble of making a careful study and I must confess that the result of that study convinced me that the program which consisted of roughly $10 billion, $8 billion as a tax cut and $1¾ billion of $50 giveaway this year, at least $8 billion was largely not spent either in that quarter or the next quarter or in the next two quarters. Perhaps it might have been spent in a dribble over many later quarters, but there is little evidence that it had a substantial effect on consumption close to the time the money was received. It must, of course, be recognized that in an economy like ours, it is difficult to clearly establish the effect; $8 billion on a personal income is a very small thing so it is hard to see what effect it has, much as it is hard to see the ripple from a stone in a troubled sea.

Nonetheless, I would like to call your attention to the chart which I have distributed and which to me makes a very clear case that no appreciable effect occurred.

The first thing that can be observed from the data graphed in the right portion of figure 1 is that there was a sharp and quite unusual increase in savings in the second quarter of 1975 of about the magnitude of the tax cut, and a corresponding sharp decline in the following quarter.

This behavior is precisely what one would expect if consumption was largely unaffected by the rebate. Indeed, the rebate caused income to rise by $8 billion (or $32 billion at annual rate) in the second quarter and to decline by the same amount in the next quarter. Hence, with consumption unchanged, saving should rise as much in the second quarter and decline as much in the third. As the figure shows, the actual increase in saving in the second quarter was even larger, some $37 billion, and the subsequent decline was distinctly smaller, suggesting that the rebate did not have much of an effect on consumption in the same or even in the next quarter.

These figures are clearly quite suggestive. To test whether this prima facie case would stand up under further scrutiny, I have carried out a very simple test reported in the chart.

First, you can see from the left portion of figure 1, that over the recent years the change in savings during any one period is very well explained by subtracting from the change in disposable income 93 percent of the change in personal income adjusted for taxes. The tax adjustment simply consists of using the previous tax rates. You can see from the chart on the left that one can thus explain quite well the change in savings year after year.

I then used that same technique to predict what should happen to savings from the second quarter of 1975 to date, on the assumption that consumers disregarded altogether the tax rebate of the second quarter. You can see that the saving so computed track quite well with what actually happened.

There is no evidence that saving, even in the first quarter or thereafter, fell significantly below what it should have been if the rebate had been totally saved. So, the indications are that it was largely, if not totally, saved.

Figure 2 analyzes the results in an alternative fashion that is even more telling, though perhaps a bit harder to understand.

Beginning in 1975 let me accumulate the savings and ask is there any evidence that the accumulated saving ever became lower than would be consistent with the hypothesis that that $8 billion was never spent?

Here the solid line is the actual accumulated saving and the broken line is the estimated saving that would have occurred if that money had never been spent. You can see that actual savings were, if anything, consistently larger than expected even assuming the rebate was not spent. The line at the bottom shows what the saving would have been if at any point within the time those $8 billion had been consumed.

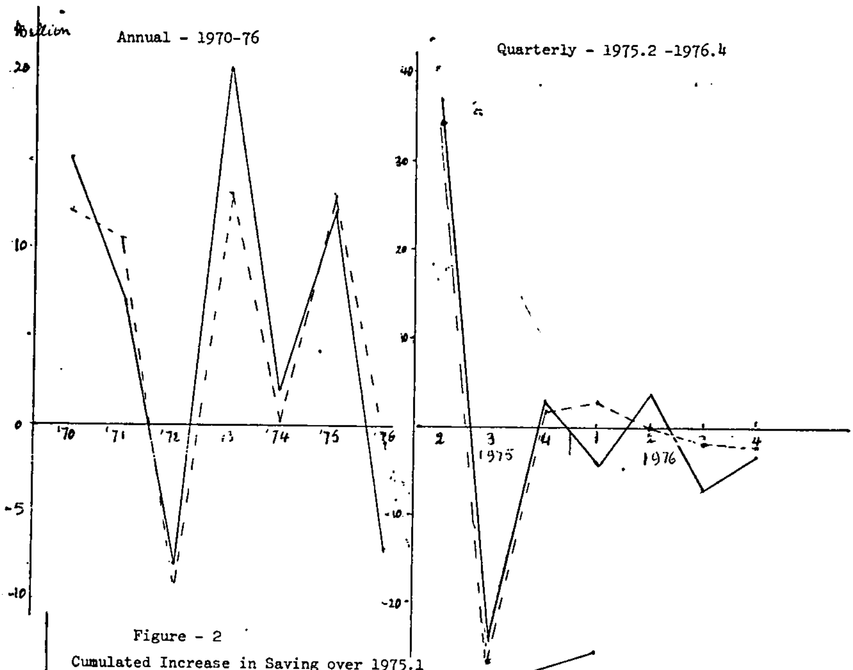
So, it seems to me very clear that there is essentially no evidence that that tax rebate had a significant effect on consumption. Only toward the end of 1976 was saving somewhat lower. But I doubt that one can trace the low saving in late 1976 specifically to $8 billion of tax rebate which came a year and a half earlier.

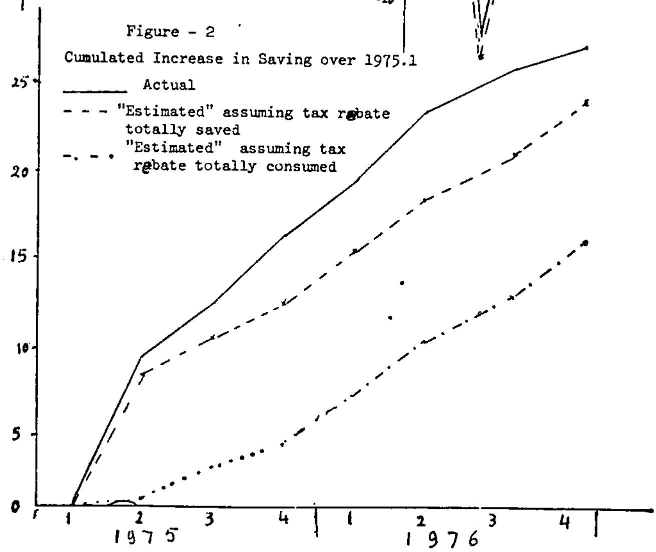
[Figures 1 and 2 referred to by Mr. Modigliani follow:]

Figure 1. - Change in saving (billon current dollars)

_______ Actual

------ "Estimated" (7% of change in Tax-Adjusted Personal Income)





Representative BOLLING. I am going to have to interrupt you briefly because Senator Javits is under some pressure and wants to ask a question, and I am sure my colleagues won't object.

Senator JAVITS. Mr. Heller, you know we can argue about the end point of judgments, et cetera, which come from the thesis that this tax rebate will be a useful stimulation.

By the way, I would like to pay tribute to a fellow New Yorker, Henry Kaufman, because I thoroughly agree with what he defines as anti-inflationary measures. I would describe these as structural changes which we will have a good chance to make, but we may not have a chance again for a long, long time. I wanted to ask this question: We have had a set of figures developed by the Library of Congress which were published in the Congressional Record January 4, 1977, on page 1432, which analyzed the tax revenues after the tax rate cuts of 1964 and which indicate a uniform pattern growing right through from 1963 to 1968 inclusive, which were years of actual revenue gains. There were rate cuts producing gains instead of losses even though some of the rate cuts were very, very high.

Some of those occurred in the Kennedy years. I wonder, Mr. Heller, whether you have studied those.

You know, I don't believe in off-the-cuff business. We are not in a game now. Either now or at your leisure may I have a thoughtful, studied reply?

You are one of the most honest men alive. You call them as you see them. Most of us don't agree with you right now and that makes me more anxious to get a very considered point of view.

Mr. HELLER. Needless to say, Senator Javits, when you talk about the tax cut of 1964, in which I have a certain paternal interest, you have to watch me pretty carefully.

Therefore, I should probably rely on the evidence that others have adduced. Arthur Okun made a detailed analysis of the impact of 1964's tax cut on the economy and in turn, of course, therefore, on revenues.

I guess if ever there was a policy measure that came out of the textbooks and, in effect, went back in in terms of confirming exactly what we had projected for it, that one comes about as close as any.

What happened to the tax cut in 1965 is difficult to pin down but insofar as we are able to isolate it, it did seem to have a tremendously stimulative effect, a multiplied effect on the economy. It was the major factor that led to our running a $3 billion surplus by the middle of 1965 before escalation in Vietnam struck us. It was a $12 billion tax cut which would be about $33 or $34 billion in today's terms, and within 1 year the revenues into the Federal Treasury were already above what they had been before the tax cut.

What obscured the effect of it was the outbreak of escalation in Vietnam that superimposed on a program targeted for full employment about $20 to $30 billion of Vietnam expenditures that knocked everything galley west.

Did it pay for itself in increased revenues? I think the evidence is very strong that it did.

Senator JAVITS. The question really is: Why shouldn't we go that route now?

Why go your route now of the rebate when history seems to confirm this tax cut kind of stimulus being the best at work and it satisfies everybody's feelings about it.

Mr. Kaufman was talking a moment ago of dealing with structural problems and Mr. Modigliani casts doubt on whether people will save a rebate or spend it and if a tax cut does the trick at all, why should we go the rebate route?

Mr. HELLER. There are half a dozen reasons for that and I will focus on just a couple of them.

First, using the permanent tax cut route makes a permanent decision about the size of the public sector versus the private sector.

If you went all the way on the permannt tax cut, let's say a $15 billion permanent tax cut you would preempt, you would use up about half of the budget margin or better that we have for all Government program additions between now and 1980.

I think that Mr. Carter has very wisely decided to hold off for a while in terms of making these fundamental decisions except for the $6 billion of permanent cuts in the form of the $4 billion for individuals and $2 billion for corporations.

All of the Carter program, is essentially—except for those $6 billion—self-terminating; the rebate, jobs programs that phase out as unemployment falls and the public works programs.

They leave the options open for later. If you put in a permanent tax cut, I think you have closed off those options and I say this in spite of having a pretty substantial vested interest in tax cuts.

There are alternative routes of stimulating the economy. One is through this combination of a tax rebate followed on by other programs that sort of pick up the beat and then options can be used for doing at least something that you want on housing, on welfare, on medical insurance, and so forth.

So, one of the really powerful arguments is that in this case, unlike the 1963–64 situation, there is a limited amount of budget room.

We had much more at that time, and the question is how you want to use that budget room. That gets into value preferences, not into economics, because you have different ways of doing this in terms of economics.

I think my value preferences show through pretty clearly. I would in this case—getting out of economics and into social preferences—prefer to have more in terms of those desperately need public-sector programs than in handing something back to the taxpayers permanently.

Senator JAVITS. My colleagues have kindly indulged me. It seems to me you read history and then you defy it. That is the way it looks to me.

Thank you.

Mr. HELLER. I truly do not think this is inconsistent with the history of the 1964 tax cut. It is a matter of choice between tax and spending instruments.

Senator JAVITS. Thank you, Mr. Heller, and Mr. Chairman.

Mr. MODIGLIANI. That is a good point for me to come to in my next question.

How does one provide temporary tax cuts?

I think I do have some sympathy with Mr. Heller. I think there is more room for a permanent tax cut than he agrees because inflation is with us and will continue for a while and that is going to increase taxes in effect.

If we want to keep a constant burden, we can afford to make concessions. So, I think we can take some of that permanently.

For that part, we want to keep transitory, I believe it is time again to remember there is only one kind of tax which is ideally suited for a temporary tax cut.

In the case of income taxes, if you say it is temporary, you make it less effective. There is, however, one case where you can say it is temporary and make it better and that is reducing excise taxes.

If you reduce an excise tax, even if it is temporary, you make an inducement for people to buy more now because things become cheaper.

Suppose a 5-percent sales tax were suspended for 3 months. People would want to buy in those 3 months. So, you get more power from a transitory tax cut and you get most of the effect while the cut is in effect.

In this country we don't have significant Federal excise taxes. If one wants to follow this path, one has to find an ingenious roundabout route.

One suggestion is making use of the State excise taxes. Let the States rebate the tax and have the Federal Government reimburse them for the lost revenue.

If that method is too fancy, and too difficult to arrange on short notice (although I think we should consider it as a tool for the future) you do have one alternative that is available, and that is payroll taxes. Payroll taxes are fundamentaly undistinguishable from excise taxes except one is added on, while the other is part of cost.

The reduction of payroll taxes will have the same effect of reducing excise taxes. It has two effects. First of all, the effect is concentrated just when you want it and second while it lasts it has the effect of reducing inflation. So, you get a double contribution. To be sure, when the tax goes back the effect on inflation is reversed, but in the meantime you have had the advantage of the wage-price spiral which I think will help get things in a better position when you have to put the tax back.

You will notice that the program of Carter includes one such element. He includes a 4-percent credit against the social security taxes. The trouble that that is "peanuts." Two billion dollars or 4 percent is so small that I think the effect of that is really a throw-away. At the present time the social security levy is 5.65 percent. This measure would reduce it from 5.65 to 5.40. The difference is so small that no one would really notice it. I think it is just too small to make any difference to anybody especially since some firms may elect to take the 2-percent investment credit.

Here, by the way, it is very unclear to me whether this part of the program is permanent or transitory. The statement by Mr. Bleumenthal says firms must elect for the next year to 5 years whether they will take the payroll deduction or the 2-percent investment tax, which suggests this program should last 5 years. Otherwise, I don't know what it means to choose for 5 years.

I think the direction is right, the method is wrong and I would favor taking that $50 rebate and investing it into this form of tax relief—a temporary reduction of social security taxes.

Perhaps one might divide that reduction equally between the employers and the employees. Then you will get some direct benefit to the employees, and some indirect effect through lower prices, increasing real income. That would produce more and faster stimulus to the economy per dollar of lost revenue.

So, then my main message on the fiscal package is that you should give real consideration to expanding this program above the present

$2 billion which is not sufficient, for I am skeptical about the $50 rebate, and would strongly argue that we use that in another direction instead which would produce more favorable effects on income as well as on inflation.

Representative BOLLING. Mr. Modigliani, I think my colleagues will strange me if I don't get to questions.

Congressman Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Heller, I would like to ask you not about the size but the composition of the stimulus package so we don't get into the cold-wave feature and let's assume we are back to when it was put together and then we will come to that effect.

First, I would say as to the amount in the 2 years as I understand it approximately 15.5 in fiscal 1977 and 15.7 in fiscal 1978.

Do you agree, not necessarily with the size but the proportions being roughly 50–50 in those 2 years?

Mr. HELLER. Roughly, although I would be willing to put a little more into the first year, say, have $20 billion the first year and then recognize that the second year should remain as the administration has emphasized: rather flexible.

I do think that we should recognize that what the administration is trying to do in this case, it seems to me, is to avoid the stop-and-go sort of appearance. They very wisely said, "Look, if you try to move in fast with a big expenditure program, you are going to spin your wheels; you are going to have an inefficient kind of program, jobs, et cetera." That has been history. As Senator Javits suggested, we ought to learn from history—and history shows you just can't gear up Federal spending fast without wasting a lot of money.

So, it very wisely puts in a rather substantial economic charge through the tax rebate and then picks up more gradually those programs that are on the spending side and are hard to get going.

I think that 2-year package does have a lot of economic, budgetary, and administrative logic to it.

Representative MOORHEAD. I think also when you were talking to Senator Javits, it might be pointed out in the period just before 1964, we were in a period of very stable prices whereas at the present time when we are talking about tax cuts we are in an inflationary period which has been and is great potential for the future.

I, for one, don't want to lock myself in so that I agree with you; and I think the present is different from the history.

Mr. Modigliani, I ask the same question of you now.

You said we need the stimulus now. You would tend to agree with Mr. Heller's distribution more in 1977 in proportion to fiscal 1978; is that correct?

Mr. MODIGLIANI. Absolutely and more than he. I think we need two-thirds now and one-third at best for next year. I think that most of the stimulus should be concentrated this year and spent differently. I would add that I have a strong view that $15 billion in the form which was recommended will not add $25 billion to GNP as expected—but much less.

Representative MOORHEAD. Mr. Kaufman, do you have any comments on that?

Mr. KAUFMAN. Yes; I did not outline my fiscal stimulus preferences in detail except that without an antiinflation agenda we have serious problems coming up.

I would prefer a much more moderate package, one that would go no higher than a $20 billion fiscal stimulus.

Representative MOORHEAD. I will come to the size of it——

Mr. KAUFMAN. I would prefer to have most, if not all, of it in fiscal 1977, and leave open what the policy ought to be in fiscal 1978.

Representative MOORHEAD. I personally tend to agree with that.

Then we can come to the question of the size.

Do you believe that the fiscal 1977 stimulus is sufficient in size, or excessive?

Mr. KAUFMAN. My perference is to have most, if not all, of it in 1977 and $15 billion to $20 billion would be my range for the fiscal stimulus, period.

Here, I would say rebates, not general rebates but rebates to the low-income and lower middle income tax brackets is what I prefer.

I would also prefer to have some public spending of a capital-intensive sort, for the inner cities or the rehailitation of a variety of things, but one that would require public capital expenditures and perhaps a small investment tax credit.

Representative MOORHEAD. Would you gentlemen agree with me, and I think Mr. Kaufman's last statement indicated he would not agree with me, that if we made the decision to increase the stimulus in fiscal 1977 that the only way to substantially increase it is through the tax route, because the best of all possible capital expenditures or public works takes a while to gear up.

Am I correct in that?

The panel seems to agree with that?

Mr. KAUFMAN. Yes, I would agree.

Mr. HELLER. I would agree.

Representative MOORHEAD. Mr. Kaufman's statement makes a great deal of emphasis on the legislative and I think I understand and agree with your general thrust of the structural reforms including the investment and education of the disadvantaged young people so that they will be the workers of the future.

That is an excellent suggestion and reduction of the incentive or disincentive to work.

You come out very strongly against the wage-price controls. I would like to ask, first, the other two members of the panel: Do you have any thoughts on what I would call price incomes policy that would be, let us say, voluntary or guidelines in nature and, if so, how urgent is that needed and on what principle should they be based?

Mr. HELLER. Congressman Moorhead, I want to say apropos to Mr. Kaufman's suggestion, the stimulus program should be coupled with anti-inflationary moves.

I would agree with that. I don't think anybody could disagree with it. Mr. Carter was putting first things first, and there is every indication that the White House is working and working hard on the anti-inflationary side of the equation.

If you will permit me to get to your question in a roundabout way, let me say that while the Kaufman anti-inflationary program is a good one, I doubt that the country would perceive it, or that his own colleagues on Wall Street would perceive it as a strong anti-inflation program applicable to, say, 1977–78.

One has to do more, and that brings me to your question.

We have to have a tougher incomes policy than we have today. It is a very prickly area and we have all been over it, around it, and the thickets are not easy to get through.

I do believe an important part of our longer run policy against inflation must be in that area.

First off, when we get down to it we have no demand-pull inflation. Demand is running $150 billion below our capacity to produce at 5 percent unemployment.

Second, we have no external shock inflation right now; that is, the type of food price explosion, oil price explosion that brought on the double-digit inflation and what accounts for what Charlie Schultze terms momentum inflation today.

There are some ominous things—draught and freeze—on the food front that may give us trouble later in the year.

Third, as to cost-push: If you have roughly 8 percent increases in labor compensation per hour per year and about a 2- to 2½-percent annual rise in productivity, there is no way you can get inflation down below a 5- to 5½-percent bedrock level. That is a price-wage spiral this time around. Somehow we have to deescalate that spiral. It is the only way this country is going to reduce inflation.

One way is by bleeding them to death with high unemployment. We are not going to accept that.

The other way is to try to cut into the spiral either through such devices, such as jawboning, persuasion, raising the visibility of the Council on Wage and Price Stability, and giving them a little more clout.

Mr. Carter said explicitly during the campaign that he was going to ask for the authority for required prenotification. Now they are talking about voluntary prenotification.

I know he wants to gentle up to this but at least he is focusing on the right problems. I think he is going to find he has to take those areas of the private economy that are anticompetitive—you are not going to beat it through anti-trust—the big powerful labor unions and the concentrated industries and work with them to deescalate their wage and price demands.

Finally, in that process, the use of the payroll tax cuts, the use of something like this payroll credit to work out a bargain, an incomes policy bargain, with labor and with business ought to be seriously considered.

I am sorry the answer had to be so long, but this is a terribly difficult area in which short answers are simply inadequate.

Representative BOLLING. We sympathize with that.

I have to go pass a resolution on the House floor to give the Joint Economic Committee another 30 days to file its report.

I would like to make sort of half of a statement. I, for one, have not given up the notion which I have had for about 30 years that one of the tools of economic policy that the Federal Government still needs is the ability of the President, on his own under a law passed by the Congress and signed by him, to cut or raise taxes in a neutral fashion by a certain percentage.

I think this situation we are in today is a good illustration that there is a need for that kind of flexibility. I am well aware of the reluctance of my colleagues at a time when we were advertising ourselves heavily of taking over more and more of the power in Washington to mention that, but I still think we need that tool.

Without asking a question, I just make that statement.

Senator Humphrey will take over.

Senator HUMPHREY [presiding]. It is a good note for you to leave on because I agree with you.

Representative BOLLING. Then it is a safe note for me to leave on.

Senator HUMPHREY. First, I must apologize to our witnesses for not being here to hear Mr. Heller's testimony and all of yours, Mr. Kaufman.

I have looked through some of it and pretty much have the feel of what you are discussing.

Mr. Heller, you and I have had some exchange of correspondence and I appreciate that very much.

I have come to the conclusion that the rebate at this time is the most effective tax tool that we have in light of the unpredictability of the economy but also in light of the 2-year program which the administration is contemplating, which gives the administration some flexibility, either stimulating more in the second year or a cutback or whatever the need may be.

I also felt that the package, even though I gather Mr. Modigliani thought it was pretty much scattered, had some merit to it in that it was attempting to blend the immediate stimulus with much needed activity in the public sector. The public sector in this country is deteriorating and we have been on a binge for private affluence at the expense of public facilities. We are privately rich and publicly poor. When you are publicly poor an awful lot of people have to depend on public facilities.

I was delighted to see the Secretary of Transportation say just yesterday maybe it was time to fix up the roadbeds. If we have a few more trains that fall off the track, I can't help but say if I were over in the Kremlin I would get up and clap my hands every time a train fell off the tracks.

No matter how many planes we have, the security of this country depends on rail transportation in the face of a national emergency.

We have not taken care of that both public and private sector.

Mr. Heller, I think you made the point here in your testimony that the Carter program leaves options open on the future spending of tax cuts.

The rebate itself preempts no future tax revenues. That is a difference between that and the permanent tax cut.

The public works program will run its course and the specific jobs program and the countercyclical revenue-sharing will phase out as unemployment drops.

Am I correct in saying that what you are saying is that this is an accordian type program; it is a flexible instrument that adjusts itself according to what the economic facts reveal at the time?

Mr. HELLER. Yes, all except the $6 billion in the form of the increase in the standard deduction.

Senator HUMPHREY. The permanent tax cut.

Mr. HELLER. Yes, all of the rest of that is the accordian type.

Senator HUMPHREY. Do I understand that you and Mr. Modigliani both feel that there could well be a larger bite, a larger stimulus, particularly in the tax item?

Mr. HELLER. Yes, I do.

Senator HUMPHREY. Did I get that from your testimony, Mr. Modigliani?

Mr. MODIGLIANI. Yes, not only in the tax area, but I think there is room for a larger package.

If we use more efficient methods, if we use the money effectively, then perhaps we do not need so much more but I think the package on the order of $20 billion would make sense at this time.

Senator HUMPHREY. I notice there is a real conflict between you and Mr. Heller in reference to the effectiveness of the rebate.

Mr. Heller, in his testimony, as I look back over it, counts what he believes to be the impact of the rebate in terms of increased stimulus, and you pointed out in your chart that it really does not amount to very much.

Is that correct?

Mr. MODIGLIANI. That is correct.

Senator HUMPHREY. Both of you gentlemen are members of the American Economic Association? You should certainly get together.

Mr. MODIGLIANI. That is a good question. Some of the answer lies in the fact that $8 billion is small. We are dealing with a magnitude which is not that great.

First of all, people come to this problem with different preconceptions. Mr. Heller comes to it with the idea that people, when they get money to spend, it does not make any difference whether it is an inheritance, an insurance settlement, or their regular wage or overtime, he thinks they behave roughly the same way. I feel people respond differently. However, when you get a $50 windfall shot, you are in a very difficult position because it is too small to be clearly treated as a one time addition to wealth. I have really approached the problem with a neutral mind. I know it could go either way. It seems to me, however, that if you look at the 1975 evidence you cannot fail to conclude that it certainly was not significantly spent in the immediate quarter or the next few quarters.

Senator HUMPHREY. I know you have to go to a luncheon at the National Economists Club. I want them to hear you, but I want to hear from you, too.

Mr. KAUFMAN. Let me try to arbitrate this.

Professor Modigliani's chart refers to recent experience in tax reduction of 1975. There is no other illustration. I think the 1975 period was rather unique in American economic and financial history; namely, that we came out of severe credit stringencies and tight credit and, therefore, easing the liquidity and lessening of the indebtedness burden was a high priority of taxpayers.

Consequently, we did not get the traditional bounce from the tax reduction. In former periods we would have had tax rebates, and I think one experience here is insufficient to tell us what is going to happen in the future.

Senator HUMPHREY. Let me interject to mention the difference as I see it between a rebate and a permanent tax cut. You were mentioning excise tax and a possible cut on payroll tax. That is economically and politically feasible.

Once you cut the payroll tax immediately a flash goes through the Congress, "You are increasing my taxes."

On a rebate you don't have that. On a rebate, it is a one-shot proposition. Any excise tax you once cut, and don't misunderstand, I think it has an effect, but the politics of it is very, very difficult.

Mr. MODIGLIANI. This can be done. What you are saying is that for the next 9 months we will rebate not 4 percent of the tax, but 25 percent of the tax. I use this figure only for illustration. For the next 9 months you can take it as a credit against your corporate income tax.

After 9 months it is finished. Just for these 9 months, you have a one-time rebate.

Senator HUMPHREY. I have mixed emotions about this, and I think I wrote to Mr. Heller about this and said on one of the TV shows where I called for a more permanent tax cut, what I consider to be the lingering specter inflation over time. But the real problem, once you tinker with the basic tax structures, it is very, very hard to get them adjusted any other way except down.

There are public needs in this country. I worry that we will get ourselves in the position where we have so tinkered with the tax rates that we will lose the revenues that are ultimately needed to take care of the many basic needs of the country. I can see how your program would work, and may I say even the State sales taxes, just as we have revenue-sharing, it would not be impossible to have a rebate to States that have these very heavy sales taxes.

May I say, Mr. Heller, we think we have a high sales tax in Minnesota, but when you go to some other places in the country, you find the taxes just abusive compared to what we have in Minnesota.

Mr. HELLER. The danger is that one gets to the point where one just makes debater's points, yet, following up your point, I do think inflation expectations are lower now than they were at the time over the 1975 tax cut. Insofar as there was a high rate of saving for a while after the tax cut, it probably was a case of consumers still providing against the erosion of the real value of their cash balances, their savings balances and so forth. Note, however, as inflation came down, the savings rate came down all through 1975 and 1976.

When I made my comparisons, instead of taking the wiggles, the quarter-to-quarter wiggles, I took the 7 quarters following that tax cut and found, as indicated in my testimony, that the saving rate, overall, was well below the average to date in the 1970's.

Finally, I think it is worth reiterating that the pressures of 1977 are such that this money is very likely to go into the spending stream, given the pressures of the cold wave, given the pressures we are going to see on some of the fruit and vegetable prices, and so forth, and given the basic spending mood which, in spite of the inroads from the cold weather, has generally been measured as favorable.

I realize some recent polls show some erosion of that, but as Mr. Kaufman suggests, you have to take into account the special factors and I would think that money would go into the economy very rapidly.

Senator HUMPHREY. I thought the analysis you gave, Mr. Kaufman, of the 1974 picture as compared to the current picture is very helpful, meaning the conditions that prevailed as you outlined in your statement, where you pointed out certain facts that were most unusual to which the economic stimulus had to be applied.

Those facts have changed considerably since then. Liquidity of business, the way that business has refinanced itself, the lower short-term interest rates—there are a lot of factors that you have listed here which I don't need to repeat, but, again, I think have to be factored in when you start to think about an economic stimulus package.

Do I understand, Mr. Kaufman, you feel there is some danger in the stimulus package?

Mr. KAUFMAN. I believe we have gone through very difficult times, Senator, and the memories of those times are with us. It is very easy to arouse inflationary expectations. I believe that we should be aware that in 1977 the financing of this deficit is not going to be done as easily as in 1975. I think it is not a matter of first things first. I think the fight against the inflation and a higher rate of economic activity have to be achieved simultaneously.

That is why I argue very strongly there should be at the same time an anti-inflation agenda by the administration, accompanying the administrative stimulus. These are the hard things that need to be done.

Senator HUMPHREY. Coming to what our former Secretary of the Treasury, Mr. Simon, worried about; namely, the crowding out theory; this case has been made time and time again. It did not happen in the recent period.

Mr. KAUFMAN. It did not happen in the sense people said they were crowded out but in the first part of 1975 there was anticipatory bond financing. Because of delayed inflation, we had liquidations of short-term indebtedness mainly by businesses. In 1977 we will see more short-term borrowing to finance inventory and to finance receivables. At the same time in 1977 as compared with 1975 we hope to have higher volume of mortgage financing.

In 1975 when we had those tax reductions, housing starts totaled 1.2 million units to 1.3 million units. This year we expect 1.8 units to 1.9 units. That means long-term credit demand will be higher.

Senator HUMPHREY. The money for the long-term credits is mainly by the S. & L.'s.

Mr. KAUFMAN. If the U.S. Government comes in and we have not settled the inflation problem, Government is going to offer Treasury bills, notes and bonds, and they from time to time have competed with S. & L.'s.

If you recall the third quarter of 1975, for example, when the savings slowed, they slowed substantially because of the issuance of Treasury notes that were attractive vis-a-vis the rates paid on savings.

Senator HUMPHREY. I recall the fancy word "disintermediation" which really means "robbing Peter to pay Paul."

Mr. MODIGLIANI. The Treasury bills rate went up not because of the issuance of Treasury bills, but because the Federal Reserve was sitting tight on the money supply, and they produced the exceedingly high rates.

Senator HUMPHREY. I appreciate your courage to touch up the temple of the Federal Reserve once in a while. I have done that in my rather crude manner and at times not too-well-informed. I just have a native suspicion. I am not sufficiently informed in terms of professional competence and will study to know all the ins and outs about the Federal Reserve.

I just know there is something not right. I know that, and no one is going to take it out of my mind. Mr. Burns does a good job, but I feel there is something amiss. Every time we get the economy moving a little bit, the Federal Reserve Board feels they have a primary responsibility to either choke off the fuel or make the old car cough a few more times or put on the brakes. I suppose that is part of their responsibility; there is no doubt about it.

I am not quite as wild in my views about the Federal Reserve this year as I was a couple of years ago because I tend to feel that the Federal Reserve, despite its pristine purity, does sense the waves of political reality and they move a little bit.

I also have a feeling this soft spoken President who comes to us with Georgia magnolias is a very, very tough fellow when he wants to be. He is a highly disciplined, well-organized man that knows what he wants, and I think if it comes down to the old crunch the President of the United States is not going to stand idly by and see this country put into a downward spiral or in further recession because of any kind of pattern of ideological fix of the Federal Reserve.

I just believe that is one of the facts that we can spread early on the record. I just believe that there is somebody in the White House and someone in the Treasury and someone in CEA who is not just going to sit idly by and see one leg of the whole system, called the monetary system, have its way entirely.

Now that is Hubert Humphrey's point of view.

Mr. HELLER. Are you saying in effect quite apart from the Federal Reserve being independent of the White House, the White House is about to declare its independence from the Federal Reserve?

Senator HUMPHREY. I could. I don't say it will declare its independence, but I think it will tend to put its shadow or whatever you wish. I have seen it happen before. All I am saying is there is accommodation.

Mr. Kaufman, thank you very much.

Mr. HELLER. Although I am putting it facetiously, I agree with you 100 percent; throughout the Kennedy years, through the so-called quadriad, it was possible to get the inputs of the Federal Reserve on other policies and have the inputs of the administration on Federal Reserve policies.

I am a little sorry Mr. Kaufman had to go, and I don't mean to be unfair to him; but I did think it might be worth, Senator, just pointing out that there is a quite different and more optimistic viewpoint on the financial wherewithal in the private economy than the one Mr. Kaufman has expressed. We all respect him. He is the sage of Manhattan, surely, on these matters; but I notice in their study that Data Resources, Inc., Otto Eckstein and his group, and Alan Sinai, have a chapter on financial shortages or surplus in their "Economic Issues and Parameters Over the Next Four Years," about the ability of the private sector to finance Federal deficits as well as the other factors.

Senator HUMPHREY. Is that a very recent publication?

Mr. HELLER. It is within the last few weeks.

Senator HUMPHREY. I want to make sure we get copies for our committee.

Mr. HELLER. They say "No shortages of finance exist today." "The rebound in the economy's liquidity and strengthening of balance sheets that has occurred since mid-1974 is without precedent in the postwar period." "The threat of financial difficulties is minimal." "Activation of financial constraints would require a sustained boom through 1980, especially in the business sector, accelerating inflation, and a prolonged dose of tight money."

I don't pose as an expert in this area, but they made a very careful analysis and it is their feeling that the financial resources to handle the Federal deficit and the growing demands of the private sector are at hand. So, we don't need the restraint, holding down the fiscal program or Mr. Burns slamming on the monetary brakes in the light of this kind of a projection.

I think we have to heed Mr. Kaufman's warnings, but I don't think we should be too inhibited in the present circumstances by those warnings on the financial cycle.

Senator HUMPHREY. The title of that publication is what?

Mr. HELLER. "Economic Issues and Parameters Over the Next Four Years."

Senator HUMPHREY. I suppose that publication is well known by Mr. Blumenthal and Mr. Schultze?

Mr. HELLER. I should think so if they have had time in between testifying to look at anything. It seems to me they are perpetually testifying.

Senator HUMPHREY. I will ask Mrs. Slater to make sure I get two or three copies. I want to send a few copies to some people over in the administration.

For 2 or 3 years we had administration spokesmen advocating the crowding out theory and this became the parlance of the day. It became the topic of conversation everywhere and people lived by the economic, political tone and environment. It is my view that with the kind of thinking Schultze, Blumenthal, the President and those who counseled him, that you are going to get a more positive feeling, namely, the ability of the Government and the private sector to handle this.

A lot of this relates to what we call attitude or opinion or spirit of confidence or whatever else it is called.

I have felt for a period of time beaten down all the time. Take, for example, what you have said here. I think both of you feel there is little chance of runaway inflation when unemployment stands at an average of 7.7. If you get it below 6, you have to have, as you indicated, some concern.

I feel that is too high, but I recognize once you start getting unemployment down in the 5 percent range, then you have to be proceeding in a cautious and effective manner. That is why our reports point out that we do need to strengthen the Wage-Price Council. We do need to have an incomes policy. I don't care whether some people like it or not, it has to be done. We have to have courage around here to do it and I think Mr. Carter is going to do it.

I think we would be better off by some legislative moves to strengthen the Wage-Price Council. We are all in this boat together and there is no reason at all why there shouldn't be the power of subpena and the right to not only expose but to dissect certain increases in prices and wages.

If we are going to move toward a 4 percent target of unemployment, which is a very difficult assignment, one to which I have dedicated myself including becoming attached to 3 percent adult unemployment and funding adult employment above 20 years of age, certain powers of Government must be exercised. That is my judgment. We have to do it and I think we need to keep it in mind.

Mr. MODIGLIANI. I would like to make a couple of points if I may because I have been waiting for the opportunity.

First, I would like to settle this question of the tax cut. I would like to say I agree with Mr. Kaufman that what I have analyzed here is a specific experience. But even allowing for a margin of error, the evidence seems overwhelming that ths rebate was largely saved at least over the following year and a half.

Incidentally, in this calculation, there was a portion of the 1975 tax cut that was permanent and the evidence suggests that it was treated like any other income. So what is in question is only that particular portion that came as a one shot rebate. Notice, this was a one-time thing. You took it off your income tax. All was done to make it clear this was once and for all.

I certainly agree this is not conclusive evidence. Yet, on the basis of this evidence, I would be against using that particular approach because there are at least serious doubts that it will be effective.

As a scholar, on the other hand, I must well favor using that temporary tax cut so we will have another piece of evidence. You would be providing us with a controlled experiment. From the standpoint of scientific curiosity, it would be a fascinating thing to see. I would be willing to make a fair bet with Mr. Heller that not more than half would be spent within 1 year.

I would like to make two other very brief points. On the question of price and wage controls——

Senator HUMPHREY. Don't misunderstand me. I am not advocating price and wage controls.

Mr. MODIGLIANI. I understand.

It seem to me it would be a wise thing once and for all for Mr. Carter or the administration to say that if we should ever have price controls, the basis of the prices will be early 1976, no matter when we apply them, so we stop the business of firms raising prices.

Senator HUMPHREY. Very much so because there is otherwise what we call anticipatory increases.

Mr. MODIGLIANI. Finally, I would like to say one other thing. There has been in connection with this 4 percent reduction in social security and 2 percent increase in investment credit, a proposal by Mr. Ullman that instead this be used for subsidizing increases in employment.

Senator HUMPHREY. They call it employment tax credit.

Mr. MODIGLIANI. I would like to warn against that procedure in that it would be extremely hard to enforce. I think it would create severe problems of competitive distortions between firms that have expanded and those that have contracted, so I would strongly recommend you keep away from it.

Senator HUMPHREY. The administration agrees with you, but having sat in on the conference at Plains, Ga., Members of the House of Representatives, indeed Mr. Ullman, feel strongly about this. I have lived around here for a long time and when there are strong feelings in the House they find their way to the Senate, but I intend to agree with you.

Mr. MODIGLIANI. I think there will be further hearings but I think that is a terrible approach.

Mr. HELLER. I agree thoroughly with the last point and the second-last point you made, both on the announcement effect on wages and prices, but this last point I agree with so strongly that you will find attached to my statement——

Senator HUMPHREY. Yes, I saw that.

Mr. HELLER. A specific response to the proposal that Mr. Ullman made, and I presented that to Mr. Ullman both in writing and verbally last Friday.

I don't think I made a dent on him, but perhaps with a continuing raising of such questions, there might be a bit of an impact. I do agree with the general proposition that the use of the tax mechanism for that kind of purpose is very inefficient.

Senator HUMPHREY. On its face it sound so good and very reasonable. It appeals to people who say, "put them to work and we will give you special tax benefits."

Mr. HELLER. That is right, it has a surface appeal and it is quick, and so forth but it would turn out to be a blot on the fiscal policy escutcheon.

Can I come back for a moment to the savings thing?

Senator HUMPHREY. Yes, please.

Mr. HELLER. I wonder whether Franco has seen Tom Juster's analysis?

Mr. MODIGLIANI. Yes, I think that analysis comes to exactly the same conclusion.

Mr. HELLER. I pity congressional committees that hear economists say that even though he comes to the opposite conclusion he agrees with me completely. Juster has a slow consumption function and that is part of it.

What about the studies in Israel that show that small changes in income such as marginal tax cuts and so forth are simply assimilated into income and spent quite rapidly, and don't conform to the permanent income hypothesis?

Mr. MODIGLIANI. I agree in principle that a small amount, like $50, could be lost. So I came to it with a very open mind. I was led to this precisely by Juster's work. He got me into looking at this.

It was so striking to see, just looking crudely at the data in the quarter when taxes went down savings went up as much.

Senator HUMPHREY. I think you will have a chance to have your scholarly study undertaken. I have a feeling Congress will support the rebate and you will have a chance a year from now——

Mr. MODIGLIANI. That would be very interesting, and let me say then it is my view that if we are going to apply that particular measure, then I fear that the fiscal package which is now being proposed is thoroughly inadequate for next year. We are not going to have growth next year above 5½ percent.

Senator HUMPHREY. I tend to agree with that. I personally feel the fiscal package's advantage is 2 years. That is a decided commitment and advantage for 2 years. But it is my honest feeling the jolt or impetus needed to get moving into the second year may be too small. I have expressed that both publicly and privately and particularly while I realize the weather situation is not as devastating as the headlines make it on the economy, it does have some impact.

I believe you indicated, Mr. Heller, that package would be increased by about $3 billion. I gather you felt the package could so be increased?

Mr. MODIGLIANI. I felt we need a package at $20 billion.

Senator HUMPHREY. I don't want to keep you gentlemen here much more. I want to ask this question of you which the staff has prepared for me on monetary policy, and I think it is worthy of your attention.

Mr. Modigliani has criticized the Fed's target range of 7 to 10 percent growth of M_2—money supply plus savings deposits—as highly unlikely to support sufficient economic growth in 1977. I would like to point out that, in fact, M_2 has been growing a good bit faster than that. In the 3 months ending in December, M_2 grew at a 13 percent rate. In the 4 weeks that ended January 19, M_2 grew at a 12.1 percent rate from the period 3 months earlier.

Was not this rapid M_2 growth due in part to moves by the Fed to ease monetary conditions late last year? And weren't these moves beneficial to the economy?

When push comes to shove, will the Fed keep its pledge not to thwart fiscal policy, or will it stick to its monetary targets?

Mr. MODIGLIANI. I do believe M_2 has something to do with it, not as clearly as M_1. I think it is true they were trying perhaps to respond to the threat of a slowdown, the threat of a so-called cooling-off. However, more recently long-term rates have risen.

In any event my point is that if, in fact, the Fed will let M_2 grow 12 percent, I think it extremely wise to revise the target upward. I don't think it should be done under the push circumstances and have people shout that the money supply is out of control. I wish the Fed would shift the target range up and then stay comfortably on the upper limit and not push against the ceiling all the time.

Senator HUMPHREY. I find myself basically in agreement but I am just one member here.

What worries me is Mr. Burns' statement that the President's package was premature. He gave evidence saying that despite the weakness and pace of business investment that physical volume over time purchases rose at 5 percent the first quarter, the most rapid advance of any quarter for 1976. That came out within 3 days of the 3.3 drop in unemployment, which 7.3 you have probably analyzed.

These two statements or these two assessments have a way of saying everything is moving in the right direction, so let's not rock the boat.

Isn't that correct? It is my judgment and I have said it in the other hearing that we would be deceiving ourselves as well as the country to presume, No. 1, the fact that the picture for the fourth quarter or final quarter was so beneficial and so good that we ought not be concerned; and second, that the unemployment rate and seasonally unadjusted unemployment rate is a personal circumstance that we ought not have included at all.

Mr. Heller, you mentioned, just in passing, on food pricing. I spoke of this the other day because the CEA's projected inflation at 5 to 6 percent for 1977, and assumed a modest increase in food prices. Now, if this is due to the weather problem more so than just the layoff problem, then if the weather continues as it has and with the drought west of the Mississippi and in some parts east of the Mississippi, the fruits and vegetables in the Southeast, we are going to have problems in food we never dreamed possible. Is that your judgment?

Mr. HELLER. I must say I have a sense of apprehension about this that is mounting week-by-week. The snow pack on the Rockies and the

Cascades and the Sierras is one-third normal. We know what drought is from our own experience in Minnesota and that is continuing, and also in the Dakotas.

Senator HUMPHREY. And back into the Colorado-Wyoming area and the wheat areas.

Mr. HELLER. If the impact on wheat, the impact on fruits and vegetables and the impact in California where they are now rationing water in Marin County, is not broken by some change in the weather patterns prices could be moving up very rapidly in the latter part of the year.

I noticed, again, not that I subscribe to the Otto Eckstein service nor am I getting any fees for these comercials, but I notice that they have raised their forecast of inflation from the 5½ percent area to 6.3 percent; and that does take this external shock of the weather into account. As I say, if the drought is not broken, we are in that respect in bad shape.

By the way, appropos of what you were saying, people are now pointing to 7.3 percent, signs of a pick-up in final sales, and so forth, as support for inaction. I have a little aphorism to answer them. Things are getting better and better but not fast enough to keep them going from bad to worse.

The basic question should be: how far are we falling short, how badly is this economy underachieving?

These month-to-month wiggles that encourage people ought to be put in perspective and not lead the Congress off course of overcoming these incredible gaps in human employment and physical utilization.

Senator HUMPHREY. What worries me, gentlemen, is we have become accustomed to a lagging economy. We have had it over such a long period of time that any little improvement is looked upon as a major improvement. If it slides back a little, we say it is not as bad it was in 1974 or the early part of 1975 which does not tell us anything except we are in serious condition.

I was concerned that the CEA looked upon increased productivity as very low, and you mentioned this yourself when you talk about incomes policy, when there are 6 and 8 percent wage increases that are trying to keep up with prices and only 2 to 3 percent in productivity. That spells out long-term trouble.

There is no doubt about that. I would think if we did get some improvement in our GNP and if we could get our industrial capacity and utilization up better than it is today we would have improved productivity. Would not that be the case?

Mr. HELLER. One of the things people keep citing is that we have had such a low increase in productivity per person hour but they may forget that in the seventies we have had two recessions and a very persistent period of slack. It may be that that long-run increase in labor productivity is not quite at the 2.5 rate per annual we had in the sixties, but you can't judge that from the record of the seventies alone. What happens is when the cycle keeps the economy below par this long, cyclical factors begin to look secular and we have trouble disentangling them. One begins to say things are petering out secularly when it may primarily be the cyclical influence.

I agree entirely if we step up the pace of total output, we will see a much better performance on the unit productivity side in the next couple of years.

Senator HUMPHREY. Gentlemen, I know we have kept you a long time. I thank you very much. I hope each of you can settle that dispute between yourselves.

I think out of this meeting what we have perceived is the concern of the mix of the package and second the feeling that this stimulus is surely not excessive and in many ways may be less than is required. At least two of you, insofar as the Government being able to finance the impending deficit, feel there is a possibility that it can be done without any serious damage if it is managed properly or without any serious difficulty. Those are the concerns the public has.

Thank you very much.

[Whereupon, at 12:34 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 8, 1977.]

THE 1977 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 8, 1977

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 345, Cannon House Office Building, Hon. Henry S. Reuss (member of the committee) presiding.

Present: Representatives Reuss, Moorhead, and Long; and Senators Proxmire and Javits.

Also present: John R. Stark, executive director; Louis C. Krauthoff II and Courtenay M. Slater, assistant directors; William R. Buechner, William A. Cox, Kent H. Hughes, Sarah Jackson, John R. Karlik, and L. Douglas Lee, professional staff members; Michael J. Runde, administrative assistant; and Stephen J. Entin and George D. Krumbhaar, Jr., minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS

Representative REUSS. Good morning.

The Joint Economic Committee will be in session, and in the absence of Chairman Bolling, I shall preside.

We turn today to the consideration of international economic issues. Chief among these are the prospects for continued economic recovery in the industrial world and the size and distribution of trade and payments disequalibria among the oil producers, the industrial countries, and the developing countries without oil.

Since these imbalances are likely to persist, financing deficit payments will remain a necessity. Who offers the financing and on what terms are the questions.

With us today, we have three outstanding experts. Professor Lawrence Klein will give us his views on the outlook for the economic growth in this country and the rest of the world. Mr. Irving Friedman will focus primarily on the problems of developing countries in financing their payment deficits, and Mr. Robert Solomon will concentrate on the payment imbalances of the industrial nations.

Gentlemen, we are most appreciative of the statements you have prepared, and they will be received in full in the record. We will now proceed first with Mr. Klein.

STATEMENT OF LAWRENCE R. KLEIN, PROFESSOR OF ECONOMICS, WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Mr. KLEIN. Thank you, Mr. Chairman.

I will read from my statement, and you will see that it spends a bit of time on contemporary outlook in the United States, because that, of course, is basic to relating it to the international situation.

By mid-summer, 1976, it became evident that the economic recovery in the United States, and also in most of our partner countries in the industrial world, was running into trouble. The beginning of the recovery was somewhat earlier in this country than elsewhere and the slowing down of the growth rate was also some months ahead of the same phenomenon elsewhere. By early autumn, there were substantial fears that the world recovery movement might abort, and the U.S. performance in this movement worsened with every week's distribution of national economy statistics. It became clear that revitalization of the American recovery through positive action by the Federal Government was absolutely necessary—both for the good of our own citizens and for those in partner countries, particularly the partner countries that were experiencing unusual difficulty on external trade and payments accounts, namely United Kingdom, Italy, Denmark, and France, to name the leading cases. The non-OPEC developing world, as a whole, depends significantly on the vigor of activity in the industrial world, and this entire sector of the world economy also needed renewal of the recovery rate. OPEC earnings fluctuate with world demand for energy, but these fluctuations are at such an elevated level that even in poor times, they are not troubled in any real sense.

This backdrop of a faltering recovery forms the economic environment in which present economic policy was formulated during the transition period between administrations, and naturally, the incoming administration had to monitor economic signals during November, December, and early January in order to decide whether to propose a stimulus and also to determine the magnitude of a stimulus package if one were needed. Economists watching trends in current statistics can be divided into three groups:

1. Those who feel that no stimulus is needed because the economy is already growing stronger on its own course.
2. Those who feel that the stimulus proposed by the new administration is of appropriate size (about $15 billion per year).
3. Those who feel that a much larger stimulus ($20 to $30 billion per year) is needed in order to lower the unemployment rate by a significant amount.

From my reading of economic statistics since last November, there is no doubt that a significant stimulus is needed. I also shall argue for the presently proposed policy package. It is true that industrial production, personal income, new orders, and some other economic readings improved in November and December, but not by striking amounts when one takes into account the fact that these were months of recovery from the Ford Motor stirke, which held down the statistics for September and October. Christmas sales were good, but not unusual enough to obviate the need for a stimulative policy. More importantly, there has been no solid visible surge yet in fixed capital formation, except for some improvement in residential construction. Capital formation is a key area to watch because the recovery since spring

1975 has been led, in this country, by inventory restocking and consumer spending, particularly for motor cars. Consumption and inventory outlays are not lasting strengths for carrying the economy forward for some years, as needed, and we have been patiently waiting for the more basic upturn in the rate of fixed capital formation in order to feel assured about the strength of the recovery.

Much ground was lost during the recession, itself, and again during the faltering recovery. That is the reason for such high and rising rates of unemployment that we experienced during much of 1976. The January unemployment rate reported on February 4 is a hopeful sign that we can expect to see improved rates during 1977, but the unusual drop of one-half of a percentage point is not to be taken at face value as a sign of turnaround in the recovery process. The labor force component of the calculation of that rate often moves in a volatile and implausible way on a seasonally adjusted basis. It appears that the manpower statisticians do not have good control over that series. The 7.3 percent unemployment rate is no more indicative of a large upward movement in the economy than is the 3 percent real growth rate of the final quarter of 1976 indicative of a downward movement in the recovery. There are strong reasons to believe that the February unemployment rate will be much worse as a result of recent shutdowns, and the employment figures for January do not look unusually strong. The lost output and the waste of human resources can be compensated for only if we start the economy moving again on an above-average growth rate. The growth of the U.S. economy in the long run has averaged about 4 percent. In order to make a noticeable impression on the incidence of unemployment, we must grow substantially in excess of that amount. This means that we must have several quarters of 6-plus percent growth to make up for the last three quarters of subpar growth. According to Wharton Model projections, we could not expect to find a series of strong quarters with above-average growth in the absence of a stimulatve policy now.

The severe winter weather of January and February has exacerbated the problem. Not only is it going to raise the unemployment figures for February, but it is likely that the growth rate of the present quarter will be only 5 percent, significantly below what had been expected on the basis of recovery from the strike-infected results of the final quarters of 1976. We can expect to see a high rate of growth in the second quarter of 1977 if there is a fiscal stimulus to the economy now and also as a result of the comeback from the bad weather shutdowns. This is what happened in the third quarter of 1975, when the tax rebate tax cut stimulus of that year first took hold. For that case, the policy actions were somewhat behind the schedule that appears to be shaping up this year.

The particular stimulus that is being proposed has many good features. While it cannot be said to be "Optimal" it is certainly to be recommended for: (1) flexibility; (2) balance; (3) magnitude.

Flexibility is much to be desired because the package is meant to be a short-term countercyclical policy to deal with the slowdown in the growth rate and should not, therefore, interfere with medium term (end-of-decade) goals of full employment, price stability, and budget balance. Also, if economic performance turns out to be better or worse than expected, it should be capable of alteration to fit the situation.

The temporary and term nature of its various parts seem to fit well with the flexibility characteristic. I think that many misleading comments have been offered about the relative importance of temporary and permanent tax changes. The evidence from 1975 suggests that a temporary tax change brings about the desired effect for stimulation of consumer demand. If an appropriate medium-term policy can be formulated to follow through right after the expiration of the temporary aspects, the appearance of the tax concessions becomes quite different in the minds of the recipients.

Balance in the program between the business and household sectors, between tax cuts and expenditure increases, and between purely temporary and more permanent changes is much to be applauded. This is because it covers some contingencies. As in all socioeconomic policies, there must necessarily be a large measure of uncertainty. We can never be sure which policies are going to work as planned, and it is important to spread risks. Diversification is a widely accepted investment principle.

A program of approximately $15 billion stimulus per year makes sense. The estimated growth path for the economy in the near term is above trend by significant amounts, and the unemployment rate should fall visibly below 7 percent by the end of 1977. These are notable achievements. The short-term budget outlook is, naturally, more unfavorable as a result of the added Federal cost of the program, but, by giving a better tone to the economy, it should lead to better budget figures by the end of the decade. In this respect, it is to be preferred to a program of inaction, which would ultimately leave us with a worse deficit in addition to a higher rate of unemployment. If the package were larger, it would generate budget deficits for the near term in excess of those that we have seen in recent years, and this, in my opinion, is to be avoided.

Given the present degree of slack in the economy, a prudent stimulus program is not inflationary. It is true that cost increases of recent months, as well as some to be incurred in 1977, are undoubtedly going to be passed on to final sales and we should expect to see some upward drift in rates of inflation. We cannot look for relief in the agricultural sector of the sort that occurred in 1976, when some basic food prices actually came down. We should be prepared for rising farm food prices, albeit at a moderate (under 5 percent), during 1977, and this will be a contributing factor to higher inflation. The important point to be made, however, is that these and other price pressures are coming regardless of the adoption of a program of economic stimulus. By itself, the program is not inflationary.

The improved rates of recovery expected for the coming quarters are going to look good to Americans. How will they look to people in other countries? In those areas of the world where external balances are unfavorable, great attention is paid to our own economic performance, with hopes pinned largely on a renewal of stronger growth rates that will make for better export markets for partner countries. It would appear that we are already doing our part by incurring a large trade deficit at the present time. It should be pointed out, however, that our deficit is lopsided. A great deal of the imbalance is with OPEC countries. This came about in 1976, but will be enlarged as a result of the oil price increase that went into effect at the beginning of the year. Coffee imports at high prices contribute further to the deficit, while on the export side, agricultural shipments have receded as a result of the fine harvests that have been realized abroad. There is little indication of an improvement in 1977 for the commodity balance (FOB), but 1978 should see a distinct narrowing of the gap, perhaps even a move to positive balance. Meanwhile, invisibles have been quite favorable, to such an extent that the goods and services balance has been completely positive. The attractiveness of the U.S. economy for world investors has meant that capital has been flowing in, giving strength to the position of the dollar, and there is every reason to believe that such strength will continue.

Real world trade recovered nicely in 1976 after having fallen in 1975. It is most unusual for this particular magnitude to fall. The recovery in 1976 was quite impressive—at about 10 percent. The international LINK model of world trade projects a continuing recovery in 1977, although at the reduced pace of 6.7 percent, but foresees a larger gain of 8 percent or more in 1978. Accompanying these gains of trade volume, there should be corresponding increases of world production. The LINK estimates project approximately 5 percent increases in major OECD countries in both 1977 and 1978. The rate of inflation has cooled off considerably throughout the world, coming down from double digit rates in 1975 to no more than about 7 percent on a worldwide basis.

That figure covers the GNP inflation for the OECD world as a whole. Consumer prices will, perhaps, be a little bit higher.

These are average or world total figures and they indicate that significant economic progress has been made in 1976, with more to come in 1977–78. While these figures look impressive, they cover up great disparities. The growth in world trade is not shared equally by all countries. There has been export-led growth in Japan and Germany. The value of exports has been and will continue to be quite favorable for OPEC and other oil exporting countries, but chronic trade deficits estimated for United Kingdom, Italy, France, and Denmark must be set against the high surpluses in the world totals.

Some improvements can be detected for the deficit countries but not to the point at which one can safely conclude that difficulties in the external accounts have passed. The slow rates of growth that occurred in 1976 and that are projected for 1977 in deficit countries resulting from restrictive policies that protect weak external positions are leading to increases in unemployment. This is a new phenomenon for many countries and not conducive to healthy social climates.

The developing countries fared poorly in the world recession year 1975. In 1976 they improved their lot but not up to target rates of 6 percent growth, except in the OPEC area, where performance was much better. Improvement is projected for 1977 and 1978 but mostly in the 4- to 5-percent range, which cannot be considered good. Debt overhang, with consequent servicing and repayment problems, casts additional doubt on ability of many dveloping countries to regain stronger expansion paths that would lead them to their long-run targets. In the socialist world, industrial recession and inflation in OECD countries, brought difficulties that compounded their 1975 harvest troubles. A legacy of trade deficits with the West and large

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foreign indebtedness tended to slow their economic progress for 1976, carrying over to 1977. Imported inflation is evident as well. It becomes clear in this past recession that the socialist economies are not at all insulated from the fluctuations and disturbances that generally affect the industrial market economies.

What might be done through implementation of economic policy to strengthen the world economy? While a strong case can be made for stimulating the U.S. economy now for our own self-interest, an added case of considerable force can be made in the interests of strengthening the whole world economy. The United States cannot do the entire job by itself, but it can take the lead and it can make a very noticeable contribution. At the end of 1975, the LINK model was used to examine the potential gain to the world economy by adding one full percentage point to the U.S. real growth rate through the imposition of a more stimulative fiscal policy (see 1976 Report of the Council of Economic Advisers, p. 135). It was concluded that the incremental point in real growth would make only a very modest contribution to the rest of the world, most of the external effect appearing in the accounts for the closest trading partners such as Canada and possibly Japan. The world economy derived great benefit from our swing from −2 percent in 1975 to +6 percent in 1976, but an incremental point in 1976 would not have gone far in helping the whole world.

Representative REUSS. Could I interrupt you at that point?

Mr. KLEIN. Yes.

Representative REUSS. I have a little difficulty with the concluding portions of this paragraph.

Up above, you say that the United States can't do the entire job by itself, but that it can take the lead and make a very noticeable contribution.

From what you have just said, an expanded growth rate is not going to make a noticeable contribution.

Mr. KLEIN. As I am going to argue, if America takes the lead and Japan and Germany join in, then you get a magnitude effect that will be noticeable. We could notice a one point change in the American growth rate, but that is not really enough to turn the world economy around.

On the other hand, if we take the lead and others follow, then there is something of much more substance.

Representative REUSS. I see.

Go right ahead.

Mr. KLEIN. The conclusion is different in 1977–78 if the U.S. example of stimulative policy is also followed by similar policies in other strong economies. The LINK model has accordingly been simulated under the hypothesis that the United States, Germany, and Japan each add 1 full percentage point to their own growth rates.

I did this by a hypothetical tax cut in Germany and Japan and expenditure stimulus in the United States.

It is still true that the greatest gains accrue to the three key countries, but the rest of the world will benefit, too, although to a lesser extent in terms of real growth rates. If in addition to the stimulative fiscal policies, the strong surplus economies of Germany and Japan upvalue their currencies by 10 percent, the other OECD countries should realize GDP expansion of an extra 0.5 percent in 1977, collectively, and 0.8

percent in 1978. Not only will the close partners of the United States benefit, but also the close partners of Germany and Japan will benefit. The way the three leading countries are distributed throughout the world economy means that the gains will be pervasive. They will be realized in world trade as well as for GDP. These stimulative policies appear to cause some added inflation in Germany and, to a lesser extent in Japan, but not by amounts that hold back real expansion nor by amounts that lead to accelerated price rises. During much of 1976 the main thrust of coordinated world economic policy among OECD countries was for restraint. This was practiced to the extent that a synchronized slowdown gave rise to fears of abortion of the recovery. The signals now suggest a change for 1977 toward coordination of stimulative measures in strong countries, led by the United States—and abetted by adjustment of exchange rates in favor of export positions of the troubled economies.

The floating rate system has worked reasonably well, and there is no reason to consider a return to fixed rates at this time, particularly when there are so many large disequilibrium positions throughout the world, but the downward adjustments of some currency values has led to resurgences of domestic inflation and jeopardized some wage stabilization programs. Dollar denominated export price indexes show flat time profiles in 1975 and 1976, suggesting that exchange rate fluctuations just about compensate domestic inflation rates. In this sense, the floating rate system is doing its job properly, but it does have the questionable property of interfering with domestic stabilization programs, especially in the field of wage rate determination.

Thank you.

Representative REUSS. Thank you very much, Mr. Klein.

Mr. Friedman.

STATEMENT OF IRVING S. FRIEDMAN, SENIOR VICE PRESIDENT AND SENIOR ADVISER FOR INTERNATIONAL OPERATIONS, CITIBANK, N.A., NEW YORK, N.Y.

Mr. FRIEDMAN. Mr. Chairman, I must begin by expressing the fact that I feel honored to have been asked to appear before this distinguished committee to review the international financial aspects of the economic outlook. In addition to the longer prepared statement that has been circulated, I have taken the liberty of preparing a much briefer presentation for this morning.

While I would be delighted to try to respond to any questions you may have on the broad ranges of your inquiry, I understand that you initially want my statement to focus on the mounting external debt of the many developing countries.

In my prepared statement, I have included a number of statistical tables on various aspects of the external debt problem. I hope you will find them useful.

My written statement examines some of the difficulties, however, with this statistical material. My main concern is that the aggregation of those national statistics on debt can be very misleading for policy purposes because of the great diversity of developing countries, the great diversity of composition of debt, and the sources of financing to the developing countries.

Only about 20 of the 100 underdeveloped countries have made important use of private banks for obtaining loans during the past few years. These are countries with relatively high growth rates and strong export performance. These countries have made very large use of private bank credit because the alternative was a marked slowdown in their development momentum, including export growth.

The international community has made various efforts to help the developing countries to sustain their development efforts through these difficult years, including action by the International Monetary Fund, the World Bank, and other development banks, and aid-donor governments, including new donors like Kuwait and Venezuela. With their help, developing countries have been able to avoid drastic setbacks.

Private lending expanded to those developing countries which have been able to meet private bank standards of credit worthiness. This accelerated a trend which has been present for decades. The private banks now play a major role in the external financing of those particular developing countries and, I believe, will continue to play a major role in the future.

As for the increased role of private banks in developing countries, first, I wish to address myself briefly to some of the troublesome questions which the increased borrowing by developing countries has raised in the minds of many observers, both official and private: The sheer size of the debt of the developing countries is large. Is it too high for them to handle? Have the private banks moved in an irresponsible manner in lending so much to what are widely perceived as poor and risky countries? Is there a danger, whether from individual country defaults or a general moratorium on debt, of a destructive impact on the international banking system and on U.S. banks in particular?

First, how high is the debt? The external, public debt of the nonoil less-developed countries grew from approximately $59 billion to $88 billion between 1973 and the end of 1975, and has by now probably reached well over $100 billion. The countries included in these totals are indicated in the attached tables to my prepared statement. Furthermore, these figures understate the total by omitting certain types of debt not reported to the World Bank, whose statistics I have relied upon in the figures I have just given.

These figures are large, and they may well get larger. They are, however, not too large for the debtors to handle—even if they do get larger. I believe they may well become larger because, as the oil-caused deficits decline, other factors of demand for external funds will be operating, such as inflation, increasing import costs, the need to rebuild monetary reserves, investment expenditures—beyond normal development needs—required to adapt economies to changed world conditions, the desire to find new sources and forms of energy, and so forth.

The countries with the highest debts today may well increase their borrowings relatively slowly, but other countries will more than offset this slowdown, in my opinion.

Therefore, we had better not assume that loan demand for developing countries will decline. The ability of a developing country to handle any level of debt, including a higher one than at present, is determined primarily by its domestic economic management and its balance-of-payments managmeent. Poorly managed countries cannot service low levels of debt; well-managed countries can manage high levels of debt.

It is to the more modern and diversified economies that enjoy relatively high per capita incomes, as well as to the faster-growing and the strong export performers, that the bulk of the private bank lending has been done. Only one of these countries, Zaire, has been unable to service—or has failed to service—its commercial debts to the private banks, and this one, Zaire, is now taking steps to do so.

Future lending to developing countries by the private banks is likely to continue to be highly selective, even though an increasing number of developing countries are able to qualify.

Have the banks behaved irresponsibly in meeting loan demand in developing countries? I think generally not, both from my personal experience and in view of the figures as to which countries have been able to borrow substantially from the private banks.

Two principal tests of responsible bank behavior are adhering to the actuarial principle of diversification and avoidance of concentration, and the extent of knowledge of the countries to which loans are made. A private bank must give a great deal of thought to identifying and anticipating risks, especially that broad area of sovereign risk and other types of risk we term "country risk" as distinguished from the standard bankers' credit risk analysis of a particular borrower's prospects.

In addition, it must always be examining its overseas portfolio to judge the acceptability of dispersion and concentration by such ratios as proportion of risk assets in any one country in relation to total assets or loans on the bank's balance sheet, or relation to capital and reserves.

My impression is that the proportion of loans in developing countries to total loans of the banking system is small for the banking system as a whole, even when all the outstandings are totaled together. This, moreover, is an aggregate ratio of very little meaning unless a holocaust is assumed that causes the major countries to default simultaneously.

More important are the ratios for any one country, particularly the big developing country borrowers like Brazil, Mexxico, and Korea. These ratios, I believe, are significant from the viewpoint of earnings, but represent no threat to the financial stability of the banks.

Again, the assumption that all loans to all types of borrowers in a major borrowing country will simultaneously be defaulted or seriously delayed in servicing by exchange control is at least far-fetched. Long before this were to happen, there would be signs of weakness, and defensive measures would be taken to reduce foreign-currency exposures. It is, I believe, only by disaggregating the external debt numbers and seeing the dispersion among countries and within countries, that we can judge country risk.

To be defended adequately against imprudent country risk, a bank must devote a great deal of managerial time and effort to controlling the level of exposure in each country to each type of borrower, by each class of maturity, and so forth. This control is exercised in such a manner as to keep it consistent both with its country risk assessments and with the actuarial principle which lies behind its diversification.

If this is done professionally, banks are in a position to strengthen their portfolios, because of many potential borrowers in credit-worthy developing countries among whom to select the credit worthy.

The last of these questions I would like to comment on is whether we are going to see defaults or a general moratorium on debt repayment which could threaten the banking system. The moratorium proposal, as it is currently being discussed in international forums, has been refined. At the insistence of some of the most credit worthy of the large developing countries like Brazil, it has become much more narrowly focused upon the debts of the poorest countries to official creditor agencies, most all of which have stemmed from official aid programs. All developing countries are demonstrating the importance they attach to retaining their credit worthiness for borrowing from private financial institutions.

My own experience to date has convinced me that there is no developing country which cannot service its private debt, and I believe a detailed examination of each individual country's unique circumstances would confirm my judgment on this point.

To say this is, however, not to dismiss the very real problems faced today by many of the poorest countries, nor some other areas where I believe national and international action could effectively be taken.

I should like to conclude my statement to the committee by outlining briefly some of the areas to which I refer.

I believe that the industrialized countries should continue and strengthen their efforts in the fields of trade and finance to assist the developing countries. My own background does, of course, give me a strong bias in favor of the multilateral approach through institutions like the IMF and the World Bank, in which I was honored to serve for nearly 30 years, the Inter-American Development Bank and the Asian Development Bank.

I would, however, recommend that the IMF give more attention to the special problems of balance of payments management of developing countries as distinguished from developed countries. The maintenance of development progress, like avoidance of unemployment and inflation, should be seen as a primary objective. This means that the IMF must have even closer links with development institutions like the World Bank and regional development banks and be more cognizant of the role that private institutions play in the developing effort.

The IMF, in my opinion, needs much greater resources to meet fully its responsibilities, but it also needs a new definition of its responsibilities, and it can then point to the amount of additional resources the Fund will require.

The Fund, I believe, can play a major role as certifier of country behavior. Private institutions will still have to make their own judgments, because they cannot duck their responsibilities. The standards and criteria by which private banks evaluate country conditions, outlook, performance and risk must be most cautious and strict; and in fact, if I may say, in most cases stricter even than the IMF.

The private banks will, however, be greatly helped by knowing that the Fund's judgments on use of the Fund's resources reflect a judgment on country performance and outlook made by an expert nonpolitical group. Judgments perceived as political cannot guide private banks.

A suggestion for further exploration is the creation of large, continuing standby facilities in the IMF, World Bank or elsewhere to enable developing countries to cope with unexpected shocks which adversely affect their balance of payments; some short lived, like droughts and frost; others more enduring, such as the oil price rise. The purpose of such "safety nets" would be to prevent needed adjustment from threatening the development momentum of the affected developing countries.

If I may say, these views reflect concerns which I have held for many years, since playing an instrumental role in the IFM's compensatory financing facility and in leading the study in the World Bank on supplementary finance. The Fund's "oil facility" was fine, but too small and temporary. The Fund's Compensatory financing is helpful, but relatively small and is not related to conditions by which other lenders can be guided. The same for the new trust fund created by gold sales. The World Bank's study on supplementary finance made in the late 1960's at the request of UNCTAD and endorsed by many developing and developed countries, was directed to the area of unexpected export shortfalls, in a manner which assured adequate and prompt financial support on appropriate terms for the threatened country, but only for sound development programs and policies which had been internationally reviewed.

Such approaches, I believe, are worthy of further exploration as we seek to support the development effort of developing countries and make the maximum use of existing official and private institutions.

I would like to end on the note of reiterating the importance of the productive use of the funds borrowed from private banks. This results from a combination of rigorous analysis of both creditors and country risks. This is the essence of insuring both the sound development of the borrower and the capability of the country to service the borrowed funds. The cost of external debt obtained from private banks is cheap either when compared with return on capital in the borrowing countries or when deflated for inflation in the creditor countries. Real interest rates are low and as long as the developing countries which borrowed from the private banks grow in real terms at the rates of the 1960's and 1970's, they are creating the capacity to service such debt with a wide margin left to add to their growth capability. Thank you.

[The prepared statement of Mr. Friedman follows:]

PREPARED STATEMENT OF IRVING S. FRIEDMAN

Mr. Chairman, I am honored to have been asked to appear before this distinguished committee to review developments affecting the world economy and United States policy choices. My own remarks will inevitably reflect my long concern with the issues before this committee, interests which date back to my first official duties at the Office of the Secretary of the Treasury from 1941 to 1946. Upon leaving the Treasury, I served from 1946 to 1964 as a Department Director of the International Monetary Fund, and later, joined the World Bank in 1964 as The Economic Advisor to the President in charge of its economic work and staff. In 1970–1971 I was appointed a Visiting Fellow of All Souls' Oxford University and was simultaneously at Yale to do a book on inflation which I published with the title 'Inflation—A World Wide Disaster'. Since 1974, I have been a Senior Vice President and Senior Advisor for International Operations at Citibank, N.A. Thus I inevitably bring to public policy questions a view which combines my experience in the U.S. government, the IMF, the World Bank, the academic world and now private banking.

While I would be delighted to try to respond to any questions you may have on the broad ranges of your inquiry, I understand you initially want my statement to focus on the problems of the non-industrialized world, including the widely publicized balance-of-payments problems of developing countries and their mounting external debt.

These are topics about which much confusion exists. Most of what we read, whether in the press or elsewhere, is over-generalized to a point where it not only fails to be helpful but even becomes misleading. For example, specific statistics which are frequently cited are usually not adequately identified and defined as to coverage of classes of borrowers and lenders, or purposes and maturities of loans, or even which countries are being referred to as so-called "developing countries", or, by some, as "less developed countries" (LDC's). Furthermore, considerable misunderstanding exists concerning the balance of payments of economically healthy developing countries, and the proper role of external borrowing. At the risk of myself over-generalizing concerning these complex issues, permit me first to present some brief observations on the problems which concern you, and upon some beneficial and practical measures that might be taken.

THE DIVERSITY WITHIN THE "THIRD WORLD"

In discussing the international financial outlook for the developing countries it needs to be emphasized at the outset that we are referring to a very large number of countries (about 100 in all) and a substantial majority of the world's population. Indeed, the two most populous countries of the world, namely China and India, are in this category. Other giants with populations of over 100 million are Brazil and Indonesia. Within this universe of developing countries is found the greatest diversity in every respect. They all share a per capita income much lower than is found in the comparatively few highly industrialized countries of the world. A number, however, like Brazil, Mexico and Yugoslavia have per capita incomes which give large portions of their population standards of living comparable to those found in the industrialized countries.

Many of the developing countries—about 20—have already achieved such a degree of modernization in production (be it manufacturing or agriculture, or both) that they can more aptly be described as "industrializing" economies rather than placed in the broad category of developing countries. An example of the dynamics of this process is that many statistics on developing countries still include Spain within the category of developing countries. On the other hand there are developing countries where modernization is only in its infancy. Even these countries, however, have islands of modernity, such as fuels, mining and tourism. In these countries, if these highly specialized activities involving a very small proportion of the population are excluded, the great mass of people are engaged in traditional activities which afford only the lowest of income whether measured in money or real terms. To say that countries have incomes of $100 per capita is to say something that is truly incomprehensible to those of us who live in modern industrialized societies. Yet this is true of a substantial proportion of the people in the developing countries.

We are all familiar with these diversities of population and income. There are other diversities, however, which are at least equally important. A number of these developing countries are endowed with fantastic natural resources like oil, iron, non-ferrous metals, rich agricultural areas, forests and large supplies of water for human use, industry and irrigation. Countries like Brazil, Mexico, Peru, Argentina, Indonesia, Zaire, Nigeria and Angola come to mind (as well as the highly publicized major oil exporters like Kuwait, Saudi Arabia, Iran and Venezuela.) Among these countries are some dependent on large oil imports like Argentina and Brazil, some which are self-sufficient in oil, like Mexico, and others which are large exporters, the names of which have become household names in the world of today.

Other developing countries are not thus endowed by nature. Their soils may be arid or desert, water may be in chronic short supply, forests may well be nearly inaccessible and deadly diseases frustrate productive activities. Countries like Chad and Mali come to mind. Still others look poor, but modern technology especially in agriculture, fertilizers, pesticides, water and transportation, can transform them into rich areas. Sudan is an outstanding example.

Other diversities are to be found in their social and economic as well as political ideologies and institutions. Many of the developing countries regard themselves as socialist and place great emphasis on state ownership of productive facilities, particularly in industry, and on reducing inequalities in distribution of income and wealth. Other countries call themselves socialist but actually practice little that we recognize as socialist doctrines or policies. A number of developing countries model themselves on the private enterprise system though even in such cases governments are frequently the owners of enterprises which in our kind of society would be owned privately. In all countries in the developing world, however, social questions like the population explosion, poverty, education and health are the main ingredients of politics as well as economics.

Another area of diversity which needs mentioning is that of the political systems. Governments which at least emphasize devotion to democratic principles are found combined with all sorts of socio-economic systems. In other developing countries, while the government is still civilian, it cannot be labeled democratic by any standards meaningful to us. And in many developing countries civilian government has given place to military government. Even these vary in the degree of personal freedom they allow and in their perception of themselves as temporary or more permanent forms of government. Most military governments in the developing world at least profess to be devoted to their own termination and the reestablishment of civilian rule.

Because of these diversities—and I have not mentioned language, race, culture, length of independence, etc.—it can be most misleading to generalize about developing countries. It is true that, despite their diversity. the developing countries tend at times to act like a homogenous group in relation to developed countries. Thus virtually all developing countries can endorse the call for a new international economic order. All can favor a worldwide attack on poverty. All can favor larger international official assistance for developing countries. All favor sustained and strong recoveries in the developed world, but favor achieving such recoveries without inflation, which raises the prices of their imported goods whether for consumption, production or capital formation.

These areas of agreement are important. However, it is often found that in the application of these general approaches great differences are found among the developing countries. For some, on issues like the price of oil or food, their strongest community of interest is with certain of the developed countries. This heterogeneity of the developing world becomes highly important when considering practical measures to improve the world economy, even if the starting point is a general consensus on the need to help the developing countries cope with their many onerous problems.

EXTERNAL CAPITAL REQUIREMENTS AND SOURCES

The starting point for most any discussion on developing countries is the fact that modern development is a process of encouraging economic growth and accelerating structural transformation, domestically and internationally. By the same token the international development effort is the combination of policies pursued by countries either bilaterally or multilaterally, globally or regionally, to assist this process of encouraging growth and accelerating structural transformation.

We are all aware that given this commitment to encouraging growth and accelerating structural transformation, developing countries are characterized by an inability to generate sufficient domestic savings to produce the desired growth, and there is a continuing need for a net inflow of resources financed by a net inflow of capital. This creates a balance of payments deficit. Furthermore, there are time lags involved in turning increased savings into productive capacity (whether for exports or for import substitution) and this further increases the short-fall in domestic resource needs, and thus the balance of payments deficit.

The economic development process as defined by modern societies and their governments is thus dependent upon external capital. This is part of what we mean by a "developing country": despite their many differences they share a chronic need for a net inflow of goods, services and technology. Expressed in financial terms, this means they normally have balance of payments current account deficits which, as time goes on, increasingly also reflect the need to service past inflows of capital. These chronic deficits can only be financed by new inflows of debt or equity capital or by grants from external donors. Lack of such financing reduces the deficits, and decreases the supply of available goods and services, thus threatening the country's development program (and often its political stability as well).

In recent years, as this Committee is well aware, events have dramatically increased pressures to expand external financing of the deficits of the developing countries. The oil price increases greatly increased their foreign exchange expenditures on imports, both of oil and of needed imports from the inflation-wracked industrial nations. At the same time, the world recession resulted in slackened demand and lower prices for the exports—largely primary commodities—of the developing countries. And throughout this period, the developing countries continued to be primarily motivated by the desire to defend their development process, the content of which varied from country to country. The international community continued, in general, to support this strategic objective of maintaining the development momentum. The consequence was that growth rates of many developing countries after 1973 exceeded the growth rates of developed countries just as they had done throughout the 1960s and early 1970's.

The international responses to the extraordinary needs of the developing countries during the last few years were on several levels and from several quarters, including governments, international official financial institutions, and private commercial banks. A few should be briefly mentioned without burdening this presentation with statistics which I have included in a statistical appendix.

The International Monetary Fund created a large temporary "Oil Facility" which greatly helped those oil-importing nations, including developing countries which made use of it. The IMF also expanded its "Compensatory Financing Facility" which relates use of the Fund's resources to declines in export earnings.

A "Development Fund", financed through sale of IMF gold holdings, is being established in the IMF to help meet the increasing financing needs of developing countries. Drawing rights or usage of the regular IMF quotas were expanded, pending a formal revision of the IMF quotas.

Actions were taken by the World Bank Group and regional development banks like the Inter-American Development Bank and the Asian Development Bank to increase capital, especially to the poorer or harder hit developing countries.

Some "aid-donor" Governments have responded with expanded bilateral "Official Development Assistance" grants and concessionary loans, as well as rescheduling their past governmental aid to various recipient countries.[1] These aid-donors now include a number of the oil surplus countries like Kuwait, Saudi Arabia and Venezuela.

Private lending has expanded greatly, significantly helping those developing countries which are able to meet private bank standards of credit-worthiness to maintain the programs essential to their economic development.

All in all, the international effective response to the special needs of the developing countries created by the extraordinary combination of adverse circumstances was most positive. It is only necessary to recall the last world-wide situation of this type, namely the Great Depression of the 1930s, to see what might have happened. More, however, could have been done, particularly for those developing countries which do not have the credit-standing to make substantial use of private bank credit. I should like to return to some recommendations of my own on this point at the conclusion of this statement.

THE INCREASED ROLE OF PRIVATE BANKS IN DEVELOPING COUNTRIES

First, however, I wish to address myself briefly to some of the troublesome questions which the increased borrowing by developing countries have raised in the minds of many observers, both official and private: Has the sheer size of the debt of the developing countries grown too high for them to handle? Have the private banks moved in an irresponsible manner in lending so much to what are widely perceived as poor and risky countries? And is there a danger, whether from individual country defaults or a general moratorium on repayment of debt, of a destructive impact on the international banking system (and on U.S. banks in particular)?

Each of these questions must be examined carefully, avoiding generalizations. First, how high is the debt? The external public debt[2] of the non-oil less-developed

[1] For U.S. practice on debt relief, see U.S. Treasury, "Report on Developing Countries External Debt and Debt Relief Provided by the United States," January 1977.

[2] Debt repayable to external creditors in foreign currency, goods or services, with an original or extended maturity of more than one year which a direct obligation of, or has repayment guaranteed by, a public body in the borrowing country. Figures show outstandings net of undisbursed commitments.

countries[3] grew from $58.8 billion to $88.0 billion between 1973 and the end of 1975 and has by now probably reached well over $100 billion; furthermore, these figures understate the total by omitting certain types of debt not reported to the World Bank. They do not include external debt incurred by private borrowers in developing countries whose debts are not guaranteed by official agencies of these countries. It also does not include debt of less than one year which is largely international trade financing of a self-liquidating character.

These figures are large and may well get larger. They are, however, not too large for the debtors to handle, even if they do get larger. I believe that they may well become larger because as the oil-caused deficits decline, other factors of demand for external funds wil be operating, such as inflation increasing import costs, the need to rebuild international monetary reserves, investment expenditures (beyond normal development needs) required to adapt economies to changed world conditions, the desire to find new sources and forms of energy, etc. The countries with the highest debts today may well increase their borrowings relatively slowly, but other countries will more than offset this slowdown, in my opinion. Therefore we had better not assume that loan demand for developing countries will decline.

The ability of a developing country to handle any level of debt, including a higher one than at present, is determined primarily by its domestic economic management and its balance of payments management. Poorly managed countries cannot service low levels of debt; well-managed countries can manage high levels of debt. A number of the principal reasons may be put briefly:

(1) Good economic management will result in growth and in modernization of agriculture, industry and trade—particularly exports. Expanding economies and growing exports create the capacity to service external debt. In addition, such countries can hope to attract foreign capital and access private bank credit, if needed. Many statistical indicators are followed to track this management, in addition to qualitative judgments covering social and political, as well as economic developments;

(2) Well-managed economies accumulate reserves and protect their access to facilities in the IMF they do not dissipate the more than average earnings they frequently experience during upswings in the world business cycle;

(3) They are constantly on the alert for new foreign market opportunities for their exports and also for the possibility of adverse reactions; they have an export strategy, and do not simply assume unchanging or neutral conditions externally;

(4) They do not assume that world inflation will go away soon, and they therefore plan import expenditures carefully to avoid unpleasant surprises;

(5) They do not encourage consumption levels and expectations in their countries which cannot be achieved or maintained;

(6) They service their external debt: they may request creditor or donor governments to renegotiate outstanding official debt as a political act of good-will but do not act unilaterally; and they see any relief from creditor governments as a form of official international assistance to them, not as the result of failure to meet their international obligations;

(7) They service their external debt to private financial institutions promptly and fully, recognizing that private institutions, particularly banks, are not in the position government creditors are, in being able to grant credit or debt relief on political grounds; doing this, such developing countries retain their credit-worthiness for new borrowing from the private banks.

(8) They ensure that any debt is used efficiently for productive purposes; in this way, even debt contracted on commercial terms creates the capacity to repay;

(9) They keep as their prime objective the economic and social progress of their countries and make clear by actions of successive governments that political changes do not change fundamental development of objectives and undertakings;

(10) They welcome inflows of foreign capital and technology on terms consistent both with their political and economic systems and institutions and the requirements and constraints within which the providers of foreign capital and technology are prepared to operate.

These are among the principles which must guide a borrowing country eager to have the benefits of a net inflow of capital. The perception of benefits must first be seen by borrower; without the demand for external loan funds there

[3] Here I am referring to the 71 countries remaining after excluding from the World Bank's Debt Reporting System both the eight reporting oil-exporters and the seven industrializing countries of Southern Europe.

is no response from suppliers of credit. There have been occasional examples of poor judgment shown by lenders and borrowers, with resutling individual losses to banks; these are exceptional, particularly in a world which has become increasingly cautious and prudent both in borrowing and lending, and do not affect any general judgments about the appropriateness of the levels of debt.

I believe the conditions of good economic management which I have just stated will be found in the great majority of countries which account for the bulk of the external debt of the developing countries.

Two further observations may be worth making concerning the level of debt. First, if one adjusts the external debt figures for price increases, one finds that the debt of these countries has expanded at something less than the growth in volume of international trade during the same period. I have attached a statistical table giving the figures. The causes of these price increases have been the OPEC price hike, the persistent worldwide inflation, and price increases due to shortages like certain food prices. The recession of 1974-75 reduced the rate of price rises, but world inflation remains significant. Borrowing countries have no choice except to adjust to higher prices for imports and to try to offset these higher import costs by increasing their earnings. Fortunately for some, such higher import costs may be at least partially offset by higher prices for their exports as well as higher export volumes. In many cases borrowing developing countries have succeeded in increasing their foreign exchange income remarkably during the last few years. This explains why for many developing countries the so-called debt service ratios have not changed significantly over the last few years nor are expected to do so in the next few years. (See Tables.) In effect, the deflation of these figures for price exchange into real terms indicates that there has not been a strategy by the developing countries to increase their dependence on external debt to finance a net increase in the inflow of goods and services into their countries, but rather a strategy to try to maintain these inflows despite the dramatic price increases.

A second observation concerning the debt figures is that it is, of course, not the size of the outstanding debt which should concern us, but rather the debt service and the ability of individual countries to handle their debt servicing burden. Debt profiles and characteristics vary widely among developing countries, from the official concessionary terms of the poorest to the commercial borrowing done by those able to borrow commercially.

In the latter group are found those developing countries which have managed to maintain their growth momentum, accompanied by rapid growth in exports and expansion of the modern sector of their economies, including industry and agriculture. Mostly they are found in the group of developing countries which have achieved relatively high per capita incomes, e.g. Brazil, Mexico and Korea. Many of these have five to ten times the per capita income of the poorer and poorest developing countries like India and Pakistan, though still well below the averages found in the industrialized countries. It is to these countries, the more modern and diversified economies, enjoying relatively high per capita income, as well as to the faster growing and the strong export performers, that the bulk of the private bank lending has been done. And none of these countries has been unable to service—or has failed to service—its commercial debts to the private banks. Future lending to developing countries by the private banks is likely to continue to be highly selective, even though an increasing number of developing countries are able to qualify.

The private banks, therefore, are not, and for the foreseeable future cannot be a substitute for large scale lending by official institutions to most of the developing countries. Such lending will be required in larger magnitudes unless it is acceptable that the growth rates in these very poor developing countries fall drastically, even below their rates of population growth.

Have the banks behaved irresponsibly in meeting loan demand in the developing countries? I think generally not, both from my personal experience and in view of the figures as to which countries have been able to borrow substantially from the banks.

Two principal tests of responsible bank behavior are adhering to the actuarial principle of diversification (and avoidance of concentration) and the extent of knowledge of the countries to which loans are made. A bank must give a great deal of thought to identifying and anticipating risk,—especially that broad area of sovereign risk and other types of risk we term "country risk" as distinguished from the standard banker's "credit risk" analysis of a particular borrower's prospects. In addition it must always be examining its overseas portfolio to judge the acceptability of dispersion and concentration by such ratios as proportion of risk assets in any one country in relation to total assets or loans on the bank's balance sheet, or in relation to capital and reserves. My impression is that the proportion of loans in developing countries to total loans of the banking system is small for the banking system as a whole, even when all the outstandings are totaled together. This, moreover, is a ratio of very little meaning unless a holocaust is assumed that causes the major borrowing countries to default simultaneously. More important are the ratio's for any one country, particularly the big developing country borrowers like Brazil, Mexico and Korea. The ratios, I believe, are significant from the viewpoint of earnings, but represent no threat to the financial stability of the banks. Again the assumption that all loans to all types of borrowers in a major borrowing country will be defaulted simultaneously or seriously delayed in servicing by exchange controls is at least far-fetched. Long before this were to happen, there would be signs of weakness, and defensive measures would be taken to reduce foreign currency exposure. It is, I believe, only by disaggregating the external debt numbers and seeing the dispersion among countries and within countries, that we can judge country risk.

To be defended adequately against imprudent country risk, a bank must devote a great deal of managerial time and effort to controlling the level of exposure in each country to each type of borrower, by each class of maturity, and so forth. This control is exercised in such a manner as to keep it consistent both with its country risk assessments and with actuarial principle which lies behind its diversification. If this is done professionally, banks are in a position to strengthen their portfolios because of the many additional potential borrowers in creditworthy developing countries among whom to select the creditworthy.

The last of these questions upon which I would like to comment briefly is whether we are going to see defaults or a general moratorium on debt repayment which could threaten the banking system. The moratorium proposal, as it is currently being discussed in international forums, has been refined. At the insistence of some of the most creditworthy of the large developing countries like Brazil, it has become much more narrowly focused upon the debts of the poorest countries to official creditor agencies, most of all of which have stemmed from official aid programs. All developing countries are demonstrating the importance they attach to retaining their creditworthiness for borrowing from private financial institutions. For American banks this means, for the most part, lending by private banks without recourse to U.S. official agencies, particularly the Export-Import Bank, in case of difficulties. The most recent example that occurs to me is the agreement which private bank creditors recently negotiated with the Government of Zaire.

My own experience to date has convinced me that there is no developing country which cannot service its private debt, and I believe a detailed examination of each individual country's unique circumstances would confirm my judgment on this point.

To say this is, however, not to dismiss the very real problems faced today by many of the poorest countries, nor some other areas where I believe national and international action could effectively be taken. I should like to conclude my statement to the Committee by outlining briefly some of the areas to which I refer.

CONCLUSION

I believe that the industrialized countries should continue and strengthen their efforts in the fields of trade and finance to assist the developing countries. Many proposals are being made to this effect, some of which will be considered by this Congress. I trust that emphasis will be placed on the financial needs of those developing countries which cannot be expected to rely on private sources for adequate amounts of external capital. I also trust that the export efforts of the developing countries will not be frustrated by restrictive actions by the industrial countries. We have fortunately learned much about how to cope with these problems, as evidenced by the world's absorption, though not without friction, of the huge expansion of the exports of countries like Japan, Korea and Hong Kong. My own background does, of course, give me a strong bias in favor of the multilateral approach through institutions like the IMF, the World Bank, the Inter-American Development Bank and the Asian Development Bank.

I would like, however, to recommend that the IMF give more attention to the special problems of balance of payments management of developing countries.

The maintenance of development progress, like avoidance of unemployment, should be seen as a primary objective. Restrictions on international payments can as readily arise from inadequacy of development assistance as from short-term or cyclical monetary and fiscal mismanagement. Exchange rate policy must serve developmental needs as well as reducing or eliminating balance of payments deficits. Developing countries' needs for current account deficits should be recognized to the extent that they result from sound development programs, though not to the extent that they arise from unsound monetary, fiscal and exchange-rate policies. The IMF should aim to help countries obtain their legitimate needs for external finance, even though it does not provide them, or else not expect these countries to abide by the same rules as more fortunate countries. This means that the IMF must have even closer links with developmental institutions and be more cognizant of the role that private institutions play in the development effort.

The IMF needs much greater resources to meet fully its responsibilities, but it also needs a new definition of its responsibilities, which can then point to the amount of additional resources that Fund will require.

The IMF role as certifier of country behavior can make a major contribution to the solution of the international financial problems of developing countries. This can only be meaningful, however, if it is clearly perceived by all concerned that country policies are made by the government of the country and that the Fund is passing on the country's performance by criteria and methods which can help guide others. Private institutions will have to make their own judgments since they cannot duck their responsibilities, but they will be greatly helped by knowing that the Fund judgments on use of its resources reflect a judgment on country performance and outlook made by an expert non-political group. The Fund will need to examine its procedures and policies to see if they can be adapted to ensure further the non-political character of their country judgments, and made available to private lenders as they are now made available to official lenders. If not, and on balance, it may not be considered feasible for a multinational official agency to do this, then private institutions will have to place even greater reliance on their own in-house capabilities to form needed country judgments.

A suggestion for further exploration is the creation of large, continuing stand-by facilities in the IMF, World Bank or elsewhere to enable developing countries to cope with unexpected shocks which adversely affect their balance of payments: some short-lived, like droughts and frosts; others more enduring, like the oil price rise. The purpose of such "safety nets" would be to prevent needed adjustment from threatening the development momentum of the affected countries. (This view reflects concerns I have held for many years, since playing an instrumental role in the creation of the IMF's Complementary Financing facility and in leading the study on Supplementary Finance done by the World Bank.) The Fund's "Oil Facility" was fine, but too small and temporary. The Fund's compensatory financing is helpful, but relatively small and not related to conditions by which other lenders can be guided. The World Bank's staff study on supplementary finance made in the late 1960s at the request of UNCTAD and endorsed by many developing countries and developed countries, tried to deal with one major area, namely unexpected export shortfalls, in a manner which assured adequate and prompt financial support on appropriate terms for the threatened country, but only for sound development programs and policies which had been internationally reviewed.

Such approaches, I believe, are worthy of further exploration as we seek to support the development effort of developing countries and make the maximum use of existing official and private institutions.

I would like to end on the note of reiterating the importance of the productive use of the borrowed funds. This is the essence of ensuring both the sound development of the borrower and the capability of the country to service the borrowed funds. The cost of external debt is cheap either when compared with return on capital in the borrowing countries or when deflated for inflation in the creditor countries. Real interest rates are low and as long as the developing countries which borrowed from the private banks grow in real terms at the rates of the 1960s and 1970s, they are creating the capacity to service such debt with a wide margin left to add to their growth capability.

Thank you.

STATISTICAL APPENDIX

TABLE 1.—GROWTH IN DISBURSED EXTERNAL PUBLIC OR PUBLICLY GUARANTEED DEBT,[1] TOTAL, BY MAJOR BORROWING COUNTRY, 1967–75

[Yearend amounts of debt outstanding in millions of U.S. dollars]

Country	1967	1971	1972	1973	1974	1975
Disbursed external public debt, total	26,337	43,724	49,686	58,820	72,000	[2] 88,000
Argentina	1,830	2,174	2,390	2,889	3,345	3,160
Bolivia	206	525	619	634	694	779
Brazil[3]	2,566	4,439	5,473	6,917	9,303	13,144
Chile[3]	1,216	2,211	2,632	3,036	3,729	(4)
Colombia	812	1,386	1,650	1,936	2,117	2,356
Mexico	(4)	3,523	3,942	5,416	8,075	11,251
Peru	635	963	1,109	1,442	2,073	2,670
Uruguay	239	291	324	344	516	614
Ghana	(4)	531	557	613	606	616
Ivory Coast	(4)	352	400	579	737	969
Kenya	(4)	307	348	405	475	520
Senegal	(4)	126	139	202	242	288
Sudan	204	291	305	354	765	980
Tanzania	(4)	285	360	460	611	787
Zaire	(4)	352	577	894	1,310	1,684
Zambia	(4)	532	572	567	678	952
Afghanistan[5]	(4)	599	679	712	769	787
Egypt	(4)	(4)	(4)	(4)	3,890	6,311
Morocco	(4)	872	922	997	1,145	1,592
China, Republic of	(4)	709	798	956	1,160	1,694
Korea, Republic of	(4)	2,234	2,691	3,199	3,982	5,227
Malaysia	(4)	493	615	653	774	1,220
Philippines	(4)	634	779	807	1,033	1,281
Singapore	(4)	199	292	400	479	521
Thailand	(4)	360	389	443	513	615
Bangladesh	(4)	(4)	50	351	1,103	1,662
India[5]	(4)	8,895	9,764	10,398	11,242	11,883
Pakistan	(4)	3,438	3,826	4,303	4,523	4,887
Sri Lanka	(4)	387	415	477	579	597
Indonesia[6]	(4)	3,362	4,109	5,001	5,878	7,875

[1] External public debt is defined as debt repayable to external creditors in foreign currency, goods, or services, with an original or extended maturity of more than 1 yr which is a direct obligation of, or has repayment guaranteed by, a public body in the borrowing country. Most military debts are not reported, although a few countries have included such obligations in their data.
[2] Citibank, office of SAIO estimate.
[3] Preliminary; subject to revision.
[4] Not available.
[5] Fiscal year ending March 31 of the following year.
[6] Oil-exporting country.

Source: World Bank Group.

TABLE 2.—COMPARISON OF INDIVIDUAL COUNTRY DEBT SHEETS WITH TOTALS OF DEBT OUTSTANDING

[Dollar amounts in millions of U.S. dollars]

Country	Yearend 1974 Total	Yearend 1974 Percent	Yearend 1974 Private banks	Yearend 1975 Total	Yearend 1975 Percent	Yearend 1975 Private banks
Total outstanding disbursed debt only [1]	$72,000	100.0	[2] $18,000	[2] $88,000	100.0	[2] $25,000
Argentina	3,345	4.6	634	3,160	3.6	522
Bolivia	694	.9	66	779	.9	115
Brazil	[3] 9,303	12.9	[3] 4,650	[3] 13,144	14.9	[3] 7,170
Chile	[3] 3,730	5.2	[3] 550	(4)	(4)	(4)
Colombia	2,117	2.9	255	2,356	2.7	365
Mexico	8,075	11.2	4,239	11,251	12.8	6,663
Peru	2,073	2.9	948	2,670	3.0	1,344
Uruguay	516	.7	100	614	.7	93
Ghana	606	.8	----------	616	.7	----------
Ivory Coast	737	1.0	151	969	1.1	271
Kenya	475	.6	19	520	.6	18
Senegal	242	.3	73	288	.3	90
Sudan	765	1.1	287	980	1.1	375
Tanzania	611	.8	16	787	.9	12
Zaire	1,310	1.8	655	1,684	1.9	887
Zambia	678	.9	212	952	1.1	346
Afghanistan	769	1.1	----------	787	.9	----------
Egypt	3,890	5.4	1,080	6,311	7.2	1,209
Morocco	1,145	1.6	107	1,592	1.8	402
China, Republic of	1,160	1.6	135	1,694	1.9	424
Korea, Republic of	3,982	5.5	641	5,227	5.9	1,004
Malaysia	774	1.1	188	1,220	1.4	540
Philippines	1,033	1.4	279	1,281	1.4	319
Singapore	479	.6	33	521	.6	30
Thailand	513	.7	23	615	.7	46
Bangladesh	1,013	1.4	14	1,622	1.8	15
India	11,242	15.6	14	11,883	13.5	19
Pakistan	4,523	6.3	84	4,889	5.5	107
Sri Lanka	579	.8	0	598	.7	----------
Total (28 countries except Chile)	62,649	----------	15,453	79,010	----------	22,386
Indonesia [5]	5,878	----------	410	7,875	----------	1,458

[1] External public debt is defined as debt repayable to external creditors in foreign currency, goods, or services, with an original or extended maturity of more than 1 yr which is a direct obligation of, or has repayment guaranteed by, a public body in the borrowing country. Most military debts are not reported, although a few countries have included such obligations in their data.
[2] Citibank, office of SAIO estimate.
[3] Preliminary; subject to revision.
[4] Not available.
[5] Oil-exporting countries.

Source: World Bank Group.

TABLE 3.—DELETED

TABLE 4.—GROWTH IN DISBURSED EXTERNAL PUBLIC OR PUBLICLY GUARANTEED DEBT [1] TO PRIVATE BANKS 1967-75

[Yearend amounts of debt outstanding in millions of U.S. dollars]

Country	1967	1971	1972	1973	1974	1975
Disbursed external public debt total	26,337	43,724	49,686	58,820	72,000	[2] 88,000
Private bank debt:						
Argentina	199.8	218.8	394.6	659.0	633.5	521.9
Bolivia	2.4	10.1	22.5	27.8	65.9	114.8
Brazil [3]	(4)	(4)	(4)	(4)	4,650.0	7,169.8
Chile [3]	(4)	284.3	454.2	504.9	550.0	(4)
Colombia	38.5	38.0	146.1	215.5	254.8	365.0
Mexico	(4)	997.1	1,292.0	2,361.1	4,239.5	6,663.4
Peru	114.9	221.4	330.2	560.1	948.1	1,344.2
Uruguay	68.8	69.5	67.7	49.0	100.0	92.8
Ghana						
Ivory Coast	(4)	44.3	56.4	135.5	150.0	271.3
Kenya	(4)	3.6	18.2	20.6	19.5	18.3
Senegal	(4)	.3		63.9	72.7	90.0
Sudan	22.4	37.7	45.1	73.4	287.5	375.0
Tanzania	(4)	21.0	22.1	20.4	16.5	12.3
Zaire	(4)	89.3	194.7	409.9	654.9	887.0
Zambia	(4)	47.3	85.1	233.6	211.9	346.0
Afghanistan [5]	(4)	1.9	.8			
Egypt	(4)	(4)	(4)	(4)	1,080.5	1,209.5
Morocco	(4)	61.9	69.2	63.8	107.2	401.7
China, Republic of	(4)	24.8	37.6	45.3	135.3	423.6
Korea, Republic of	(4)	223.4	239.2	313.3	640.8	1,004.2
Malaysia	(4)	100.2	169.8	169.7	187.7	539.9
Phillippines	(4)	252.2	269.9	215.2	279.2	319.4
Singapore	(4)	.5	3.8	32.8	32.8	30.0
Thailand	(4)	2.7	7.5	8.7	23.4	45.6
Bangladesh	(4)			13.1	14.5	15.3
India [5]	(4)	55.3	47.6	29.6	13.8	19.5
Pakistan	(4)	64.2	67.8	61.8	84.1	107.0
Sri Lanka	(4)	2.5	1.6	.7	.2	
Indonesia [6]	(1)	.7	172.5	346.2	410.1	1,458.2

[1] External public debt is defined as debt repayable to external creditors in foreign currency, goods, or services, with an original or extended maturity of more than 1 yr which is a direct obligation of, or has repayment guaranteed by, a public body in the borrowing country. Most military debts are not reported, although a few countries have included such obligations in their data.

[2] Citibank, office of SAIO estimate.

[3] Preliminary; subject to revision.

[4] Not available.

[5] Fiscal year ending March 31 of the following year.

Source: World Bank Group.

TABLE 5.—GROWTH IN VALUE OF EXTERNAL PUBLIC DEBT COMPARED WITH VOLUME OF DEBT AND VOLUME OF WORLD TRADE

[In millions of U.S. dollars]

Year	Disbursed external public debt [1]	International price index [2]	External public debt 1975 prices	Year-to-year percent change volume of— External public debt	World trade [3]
1967	26,337	47.2	55,800		
1968	29,785	46.9	63,510	13.8	13.3
1969	33,706	48.7	69,210	9.0	11.3
1970	38,233	52.1	73,385	6.0	8.7
1971	43,724	55.3	79,070	7.7	7.1
1972	49,686	60.2	82,535	4.4	8.7
1973	58,820	71.4	82,380	−.2	12.8
1974	72,000	87.3	82,474	.1	3.0
1975	[4] 88,000	100.0	88,000	.1	−5.0
1976					
Average annual rate of growth 1967-75 (percent)	15.9		5.2		8.0

[1] World Bank Group, World Debt Tables, 1976.

[2] The international price index is based on U.S. dollar prices for exports of manufactures from DAC-member couuntries (SITC categories 5-8) to all destinations.

[3] Based on International Monetary Fund, International Financial Statistics, 1976.

[4] Citibank, office of SAIO estimate.

TABLE 6.—DEBT SERVICE RATIOS,[1] BY MAJOR DEBTOR COUNTRY, 1971-75

[In percent]

Country	1971	1972	1973	1974	1975
Argentina	20.2	20.5	18.1	16.5	23.1
Bolivia	12.0	17.8	15.2	11.4	16.6
Brazil [2]	16.2	15.6	12.2	13.8	(3)
Chile [2]	20.7	11.5	11.6	11.5	(3)
Colombia	14.2	12.5	13.2	16.1	11.4
Mexico	22.8	22.3	23.8	18.7	25.4
Peru	19.2	18.3	31.7	23.9	22.5
Uruguay	22.4	30.4	22.6	32.5	45.5
Ghana	7.1	3.2	2.1	2.3	(3)
Ivory Coast	6.9	7.5	7.2	7.9	11.7
Kenya	3.8	4.2	4.0	3.1	3.2
Senegal	5.0	3.7	8.0	(3)	(3)
Sudan	11.9	12.0	10.4	18.6	18.3
Tanzania	5.3	8.7	5.4	4.6	5.3
Zaire	5.3	8.0	8.5	11.5	(3)
Zambia	9.9	10.3	28.8	5.0	8.0
Afghanistan	18.3	15.1	19.3	17.7	(3)
Morocco	11.5	10.6	9.9	6.4	(3)
China, Republic of	4.5	4.1	3.6	2.7	4.0
Korea, Republic of	22.5	18.3	11.7	11.1	11.2
Malaysia	2.6	2.6	2.0	2.3	3.1
Philippines	6.5	8.9	8.6	4.9	7.2
Singapore	.6	1.0	.6	.5	.6
Thailand	3.2	2.7	2.6	1.9	2.5
Bangladesh	(3)	(3)	2.3	5.8	20.6
India	23.6	22.5	19.6	(3)	(3)
Pakistan	24.3	16.7	17.5	14.5	16.0
Sir Lanka	10.6	13.5	12.8	12.0	20.0
Indonesia [4]	7.4	6.5	9.5	5.1	6.7

[1] Debt service payments as a percent of exports of goods and nonfactor services External public debt is defined as debt repayable to external creditors in foreign currency, goods or services, with an original or extended maturity of more than 1 yr which is a direct obligation of or has repayment guaranteed by, a public body in the borrowing country Most military debts are not reported, although a few countries have included such obligations in their data

[2] Preliminary; subject to revision

[3] Not available

[4] Oil-exporting country

Sources: Debt data—World Bank Group Export data—International Monetary Fund, International Financial Statistics, January 1977.

TABLE 7.—INTERNATIONAL RESERVE POSITION OF MAJOR DEBTOR COUNTRIES, 1971–76

[In millions of U.S. dollars at yearend]

Country	1971	1972	1973	1974	1975	Latest 1976 available
Argentina	290	465	1,318	1,315	452	[1] 895
Bolivia	54	60	72	194	156	[2] 197
Brazil	1,746	4,183	6,415	5,272	4,034	[3] 4,590
Chile	221	148	180	102	109	[4] 453
Colombia	203	325	534	449	521	[4] 1,158
Mexico	952	1,164	1,355	1,395	1,533	[2] 1,501
Peru	424	484	568	968	467	[6] 332
Uruguay	181	198	232	217	166	[1] 225
Ghana	48	107	189	94	150	[4] 104
Ivory Coast	89	87	88	66	103	[2] 46
Kenya	171	202	233	193	173	[4] 275
Senegal	29	38	12	6	31	[2] 20
Sudan	28	36	61	124	36	[4] 24
Tanzania	60	120	145	50	65	[4] 112
Zaire	146	178	235	140	59	[2] 145
Zambia	283	165	193	172	149	[3] 86
Afghanistan	62	56	61	67	115	[4] 155
Egypt	149	139	363	356	294	[3] 284
Morocco	174	237	266	417	377	[3] 479
China, Republic of	704	1,039	1,123	1,191	1,169	[2] 1,676
Korea, Republic of	571	740	1,094	1,056	1,550	[2] 2,620
Malaysia	818	981	1,342	1,618	1,524	[1] 2,420
Philippines	382	551	1,038	1,504	1,360	[4] 1,640
Singapore	1,452	1,748	2,286	2,812	3,007	[3] 3,292
Thailand	877	1,052	1,306	1,858	1,775	[4] 1,893
Bangladesh	(7)	(7)	144	138	148	[4] 289
India	1,206	1,180	1,142	1,325	1,373	[2] 3,003
Pakistan	189	281	480	461	406	[4] 532
Sri Lanka	50	60	87	78	58	[4] 92
Indonesia [8]	187	574	807	1,492	586	[4] 1,499

[1] October.
[2] November.
[3] September.
[4] December.
[5] March.
[6] July.
[7] Not available.
[8] Oil-exporting country.

Source: International Monetary Fund, International Financial Statistics, February 1977.

TABLE 8.—EXTERNAL DEBT TO GROSS NATIONAL PRODUCT RATIOS, BY MAJOR DEBTOR CO Y. 1970-75 [1]

[In percent]

Country	1970	1971	1972	1973	1974	1975
Argentina	7.7	8.1	8.2	9.1	8.9	7.9
Bolivia	49.7	48.7	52.0	47.2	44.8	44.0
Brazil	15.7	7.6	8.1	8.7	9.7	12.2
Chile	33.6	31.1	35.3	40.0	42.9	(2)
Colombia	17.9	17.8	18.9	19.4	18.2	17.9
Mexico	8.2	8.2	8.2	9.9	12.8	15.8
Peru	13.0	12.5	13.1	15.2	18.7	21.3
Uruguay	10.3	10.7	11.8	11.7	15.7	16.7
Ghana	16.9	16.5	17.1	16.9	14.7	13.4
Ivory Coast	13.8	17.1	17.4	22.5	25.2	28.9
Kenya	18.0	17.1	17.8	18.1	18.2	17.9
Senegal	9.7	9.9	11.1	14.8	15.2	15.6
Sudan	18.0	17.4	15.5	11.8	22.1	21.7
Tanzania	14.9	16.5	19.0	21.9	26.3	30.7
Zaire	13.7	13.8	21.3	29.3	37.1	45.0
Zambia	31.5	29.2	28.5	27.0	27.4	35.9
Afghanistan	42.5	44.7	47.3	43.7	41.0	36.4
Egypt	(2)	(2)	(2)	(2)	38.1	54.7
Morocco	16.2	17.8	17.4	17.2	16.2	20.2
Republic of China	8.6	8.5	8.2	8.3	9.1	11.9
Republic of Korea	21.5	22.9	24.8	23.8	24.9	28.0
Malaysia	8.0	9.7	11.0	9.9	9.8	14.0
Philippines	6.7	6.8	7.7	6.9	7.6	8.1
Singapore	5.2	6.4	8.0	9.4	9.6	9.2
Thailand	4.2	4.1	4.1	4.0	4.0	4.2
Bangladesh	(2)	(2)	.8	5.4	12.8	18.4
India	13.3	13.8	14.7	14.2	14.0	12.9
Pakistan	47.5	53.1	56.4	56.0	51.6	49.7
Sri Lanka	24.5	29.4	29.4	30.0	32.8	30.1
Indonesia [3]	21.8	23.3	25.6	26.6	27.0	32.6

[1] Disbursed external public debt outstanding at yearend. External public debt is defined as debt repayable to external creditors in foreign currency, goods, or services, with an original or extended maturity of more than 1 yr which is a direct obligation of, or has repayment guaranteed by, a public body in the borrowing country. Most military debts are not reported, although a few countries have included such obligations in their data.

[2] Not available.

[3] Oil-exporting country.

Source of debt data: World Bank Group.

TABLE 9.—GROWTH IN REAL GROSS NATIONAL PRODUCT COMPARED WITH GROWTH IN EXTERNAL DEBT, 1970–75

Country	Year-to-year change in percent					Percent of average annual rate of change 1970–75
	1971	1972	1973	1974	1975	
1. Argentina:						
GNP	3.3	4.4	3.6	7.0	−0.2	3.7
Debt	14.1	9.9	20.9	15.8	−5.5	12.1
2. Bolivia:						
GNP	6.9	6.0	6.7	4.9	5.2	5.9
Debt	10.1	17.9	2.4	9.5	12.2	9.9
3. Brazil:						
GNP	11.4	11.0	11.9	9.8	3.4	9.9
Debt	−14.2	23.3	26.4	34.5	41.3	22.6
4. Chile:						
GNP	9.3	5.3	−3.8	4.3	−14.7	−1.0
Debt	6.2	19.0	15.3	22.8	(2)	[3] 16.0
5. Colombia:						
GNP	6.1	7.8	7.6	6.5	4.0	6.7
Debt	10.9	19.0	17.3	9.3	11.3	14.0
6. Mexico:						
GNP	3.4	7.3	7.3	5.4	3.8	5.8
Debt	9.2	11.9	37.4	49.1	39.3	29.5
7. Peru:						
GNP	5.7	6.2	5.2	7.0	3.6	5.7
Debt	7.2	15.2	30.0	43.8	28.8	25.7
8. Uruguay:						
GNP	.9	−3.6	1.3	2.2	2.6	.2
Debt	7.8	11.3	6.2	50.0	19.0	18.3
9. Ghana:						
GNP	5.5	−2.7	4.9	4.0	2.0	2.6
Debt	8.6	4.9	10.1	−1.1	1.6	4.8

TABLE 9.—GROWTH IN REAL GROSS NATIONAL PRODUCT COMPARED WITH GROWTH IN EXTERNAL DEBT, 1970–75—Continued

Country	Year-to-year change in percent					Percent of average annual rate of change, 197–75
	1971	1972	1973	1974	1975	
10. Ivory Coast:						
GNP	5.9	7.1	5.9	3.7	5.4	5.6
Debt	37.5	13.6	44.7	27.3	31.5	30.2
11. Kenya:						
GNP	8.4	4.9	8.1	6.2	2.1	6.1
Debt	8.1	13.3	16.4	17.3	9.5	13.7
12. Senegal:						
GNP	14.8	−6.3	3.2	6.6	7.0	3.8
Debt	22.3	10.3	45.3	19.8	19.0	23.8
13. Sudan:						
GNP	4.2	12.8	44.3	5.0	19.8	17.9
Debt	5.8	4.8	16.1	116.1	28.1	30.8
14. Tanzania:						
GNP	3.3	5.7	4.5	.9	1.5	3.3
Debt	20.8	26.3	27.8	32.8	28.8	27.7
15. Zaire:						
GNP	5.9	2.5	6.3	5.5	−2.6	3.9
Debt	12.8	63.9	54.9	46.5	28.5	44.2
16. Zambia:						
GNP	−.6	5.9	−1.3	7.4	−1.4	2.3
Debt	−2.9	7.5	−.9	19.6	40.4	10.4
17. Afghanistan:						
GNP	2.5	2.8	7.0	5.0	6.1	4.8
Debt	13.2	13.3	4.9	8.0	2.3	8.3
18. Morocco:						
GNP	6.1	3.9	3.0	11.3	2.7	5.4
Debt	22.3	5.7	8.1	14.8	39.0	15.1
19. Republic of China:						
GNP	11.7	11.9	11.9	.6	2.8	7.9
Debt	16.4	12.6	19.8	21.3	46.0	21.3
20. Republic of Korea:						
GNP	9.2	7.0	16.5	8.6	7.4	10.1
Debt	21.9	20.5	18.9	24.5	31.3	22.7
21. Malaysia:						
GNP	6.2	6.0	12.1	8.8	1.1	7.5
Debt	35.4	24.7	6.2	18.5	57.6	23.8
22. Philippines:						
GNP	5.9	4.2	9.9	5.8	6.0	6.6
Debt	13.0	22.9	3.6	28.0	24.0	17.4
23. Singapore:						
GNP	11.2	12.5	9.7	6.8	4.4	9.1
Debt	42.1	46.7	37.0	19.7	8.8	31.3
24. Thailand:						
GNP	7.8	4.1	10.2	4.9	5.6	6.6
Debt	11.8	8.1	13.9	15.8	19.9	13.5
25. India:						
GNP	2.6	−.8	3.7	.4	5.0	1.9
Debt	12.1	9.8	6.5	8.1	5.7	8.3
26. Pakistan:						
GNP	.3	.6	7.0	3.9	3.2	3.3
Debt	17.9	11.3	12.5	5.1	8.0	10.6
27. Sri Lanka:						
GNP	−1.1	2.9	6.6	.8	3.2	2.8
Debt	24.4	7.2	14.9	21.4	3.1	14.1
28. Indonesia:						
GNP	5.7	4.4	10.8	5.6	2.1	6.3
Debt	16.0	22.2	21.7	17.5	34.0	21.7

[1] External public debt is defined as debt repayable to external creditors in foreign currency, goods, or services, with an original or extended maturity of more than 1 yr which is a direct obligation of, or has repayment guaranteed by, a public body in the borrowing country. Most military debts are not reported, although a few countries have included such obligations in their data.

[2] Not available.

[3] 1970–74.

Source: World Bank Group.

TABLE 10.—EXPORTS OF GOODS AND SERVICES, 1971-75

[Balance of payments basis in millions of U.S. dollars]

Country	1972	1973	1974	1975	Percent of average annual rate of change, 1972-75
Argentina	2,321	3,751	4,753	3,591	16.7
Bolivia	224	303	597	481	34.6
Brazil	4,508	7,029	9,365	9,983	30.6
Chile	1,008	1,382	2,201	1,533	18.8
Colombia	1,229	1,587	1,948	2,158	20.8
Mexico	3,817	4,840	6,375	6,252	19.2
Peru	1,166	1,369	1,880	1,785	17.3
Uruguay	352	415	480	501	12.8
Ghana	447	654	746	845	22.6
Ivory Coast	772	1,004	1,454	1,188	18.1
Kenya	587	711	973	990	20.7
Senegal	349	371	(1)	(1)	(1)
Sudan	371	483	446	513	9.3
Tanzania	412	456	488	494	6.3
Zaire	758	1,131	1,514	------	------
Zambia	829	1,203	1,480	882	4.0
Egypt	1,121	1,421	2,379	2,615	35.8
Morocco	946	1,302	2,131	2,024	32.0
Republic of China	3,387	5,154	6,499	6,274	23.1
Republic of Korea	2,226	4,136	5,352	5,884	37.3
Malaysia	1,877	3,270	4,571	4,191	31.6
Philippines	1,480	2,455	3,527	3,170	30.3
Singapore	3,119	4,972	7,758	8,003	38.7
Thailand	1,590	2,133	3,172	2,988	25.7
Bangladesh	(1)	423	426	397	[2] −3.2
India	2,739	3,322	(1)	(1)	(1)
Pakistan	742	1,129	1,268	1,387	22.0
Sri Lanka	368	427	576	635	21.4
Indonesia [3]	1,802	3,044	6,956	7,025	63.4

[1] Not available.
[2] 1973-75.
[3] Oil exporting country.

Source: International Monetary Fund, "International Financial Statistics," January 1977.

TABLE 11.—EXPORTS TO IMPORT RATIOS, BY MAJOR DEBTOR COUNTRY, 1970-75 [1]

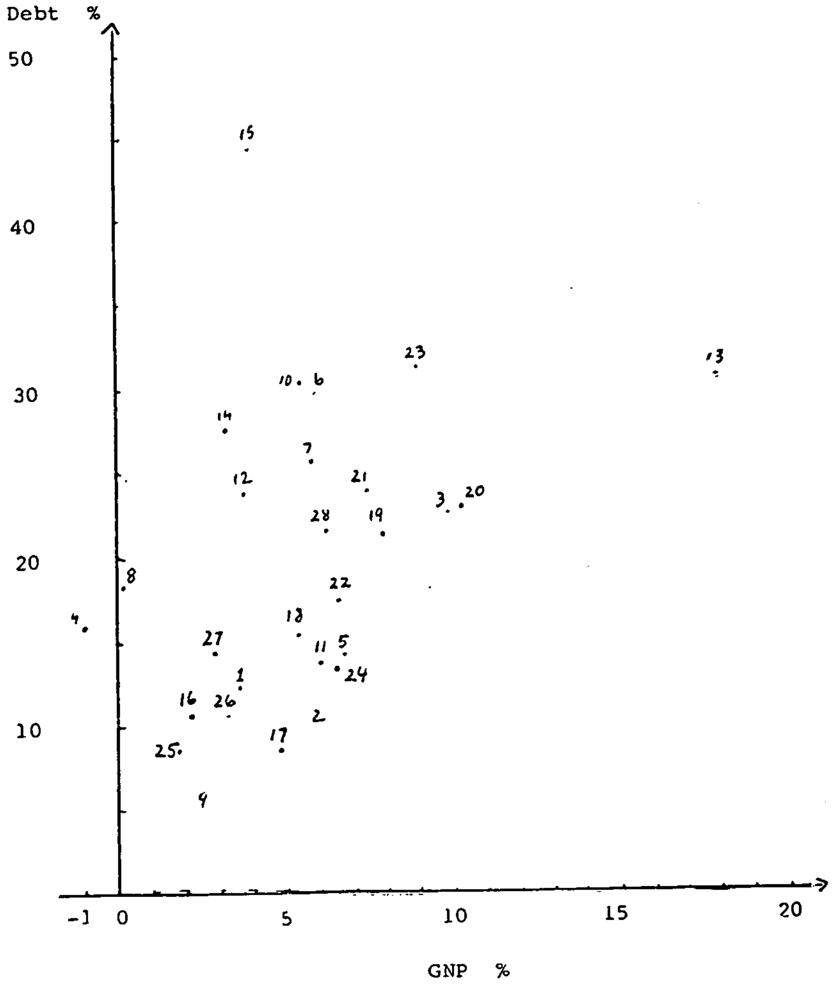
[In percent]

Country	1970	1971	1972	1973	1974	1975
Argentina	93.2	84.7	91.4	123.1	102.3	73.6
Bolivia	88.6	81.1	79.2	89.3	111.3	73.3
Brazil	84.3	71.5	75.1	79.7	56.6	59.7
Chile	98.0	85.9	68.7	74.7	85.0	70.2
Colombia	75.6	67.1	84.5	94.6	82.9	90.6
Mexico	72.2	77.8	79.6	76.5	68.1	59.9
Peru	110.7	93.8	94.3	81.8	70.9	52.5
Uruguay	84.1	77.8	115.4	104.5	75.7	69.9
Ghana	87.8	72.7	127.3	121.1	79.4	91.8
Ivory Coast	97.9	91.4	94.0	88.8	102.2	85.9
Kenya	87.2	75.7	85.7	82.1	74.2	81.4
Senegal	83.4	76.7	86.6	70.0	(2)	(2)
Sudan	88.6	89.8	86.3	105.0	60.1	51.9
Tanzania	86.9	76.8	87.0	80.2	60.6	60.4
Zaire	99.5	76.6	67.9	83.1	75.2	(2)
Zambia	88.1	88.2	91.7	128.7	115.9	64.4
Egypt	68.2	68.1	70.6	71.6	63.6	53.2
Morocco	78.2	81.5	91.3	89.9	95.5	66.0
Republic of China	99.2	107.2	117.1	112.3	85.2	92.0
Republic of Korea	63.3	61.4	80.4	89.3	70.4	73.6
Malaysia	103.8	96.6	90.8	105.4	95.6	96.9
Philippines	88.8	91.1	89.0	111.1	88.0	71.9
Singapore	78.0	76.1	85.4	89.2	87.8	91.9
Thailand	79.7	85.4	93.5	91.8	90.6	81.3
Bangladesh	(2)	(2)	(2)	45.4	36.5	28.8
India	78.3	71.8	86.3	80.6	(2)	(2)
Pakistan	51.1	53.8	63.9	81.1	51.0	49.3
Sri Lanka	84.2	88.1	89.1	91.8	76.4	77.1
Indonesia [3]	76.0	76.2	81.1	79.4	100.6	86.1

[1] Exports and imports of goods and services (balance-of-payments basis).
[2] Not available.
[3] Oil-exporting country.

Source: International Monetary Fund, "International Financial Statistics," January 1977.

Growth in Real GNP
compared with
Growth in External Debt
Avg. Annual Rates, 1970-1975



SEE: Table 9 for numerical order of countries.

Representative REUSS. Thank you, Mr. Friedman.
Mr. Solomon.

STATEMENT OF ROBERT SOLOMON, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. SOLOMON. Thank you, Mr. Chairman. I am pleased to appear before this committee. As requested, I will focus on the balance-of-payments problems of the industrial countries.

The international imbalances of the industrial countries and also of the developing countries have two components these days: A part that is adjustable and a part that must be accepted as unadjustable. The unadjustable part is a reflection of the fact that the OPEC countries have a surplus that is incompressible in the short run. If the 13 OPEC nations as a group have a current account surplus of about $45 billion, it follows that the rest of the world will have a current account deficit of about $45 billion. This, we may call the oil deficit. For the time being, the oil deficit is not correctible as long as the OPEC cartel holds together and in the absence of stringent measures to conserve oil. It has to be accepted and financed.

But the aggregate $45 billion oil deficit can be distributed among the oil importing countries in various ways. It is well known that the recession in the industrial countries forced an extraordinarily large share of the deficit on developing countries in 1975. Even among the OECD countries, the inevitable oil deficit is badly distributed.

Thus while the OECD nations as a group had a current account deficit of about $23 billion in 1976, Germany, Japan, and Switzerland each had a current account surplus of about $4 billion. This meant that a deficit of $35 billion had to be shared by the other 21 OECD countries. Of this $35 billion, the United Kingdom, France, and Italy together accounted for about $12 billion. The smaller OECD countries also had large deficits, aggregating about $14 billion.

If we focus on the balance of payments of an individual country—as the world has focused on Britain in recent months—it is not difficult to identify policy measures that should be taken to reduce the balance-of-payments deficit.

What should not be forgotten is that such corrections have to occur in a system where the industrial countries as a group have an incompressible deficit corresponding to the OPEC surplus. If Britain and Italy and other countries adopt policies that seem to be called for when their economies are looked at in isolation, to which countries will their deficits be shifted? The developing countries and the smaller OECD countries have already been carrying too large a share of the aggregate oil deficit. Clearly, one has to expect Germany, Japan, and the United States, plus the Netherlands and Switzerland, to accept a larger share of the aggregate deficit if we expect the United Kingdom, Italy, and other countries to reduce their deficits.

The oil deficit, Mr. Chairman, is a hot potato and someone has to hold it as long as the OPEC surplus remains so large.

I am afraid that is a statement I made once before, to Senator Proxmire's committee. I hope you don't mind my repeating the "hot potato" analogy.

Now, it so happens that the countries with surpluses or disproportionally small deficits also have ample scope to expand their domestic economies. As Larry Klein said a moment ago, this is not completely a coincidence. The countries with strong balance-of-payments positions have expanded domestic demand too slowly. This is true for Germany—where real GNP increased at an annual rate of only 2 percent in the second and third quarters of 1976—of Japan—where real GNP increased only 1.3 percent, annual rate, in the third quarter of 1976—for Switzerland—where real GNP was virtually unchanged in 1976 though the volume of its exports increased 10 percent—and it is true for the United States, where real GNP expansion slowed after the first quarter of 1976.

It is now commonplace to recommend that Germany, Japan, and the United States should take the lead in adopting domestic stimulative policies. This proposal was first put forward by a group of 16 private economists from Europe, Japan, and North America, meeting at the Brookings Institution in early November. With your permission, Mr. Chairman, I would like to submit for the record the tripartite report entitled "Economic Prospects and Policies in the Industrial Countries." [1]

Representative REUSS. Is that trilateral, or just tripartite?

Mr. SOLOMON. Just tripartite.

Among the three major countries that should take the lead, and there are other countries that should also participate, we know that in the United States, one of the three leading countries, the administration has proposed a stimulative program. It appears that Japan will also move. Action by Germany is more uncertain. We all understand Germany's desire to avoid inflation. Yet today unemployment is high in Germany; employment actually fell in 1976. Without the strong increase in exports—more than 13 percent in real terms in 1976—Germany's unemployment rate would be much higher. With its open economy—and the possibility of suspending any remaining barriers to imports—Germany can count on a substantial increase in imports as it adopts more expansive domestic measures.

Such an increase in imports would help to hold down inflation in Germany and would provide a much-needed lift to the other countries of Europe.

Since the German leaders did not hesitate to lecture our British friends during Britain's recent economic and financial troubles, a lecture directed at Germany should not be out of order. Too large a surplus—when the normal position, thanks to OPEC, should be a defict—calls for just as severe a lecture as too large a deficit.

I am not saying that some countries in deficit do not need to take measures to reduce their deficits. What I am saying is that these deficits cannot be eliminated, as long as OPEC surpluses persist.

I am also saying that all industrial countries should take a reasonable share of the aggregate oil deficit. That includes the United States. If one excludes oil imports, the United States has a strong surplus on current account. Given our size in the world economy, and our ability to attract foreign capital, we should be carrying a larger share of the aggregate oil deficit.

Let me conclude with a word about international debt to supplement what Mr. Friedman has said. What I have to say on this subject applies to developing as well as developed countries.

[1] The report referred to may be found in the committee room files.

The OPEC surplus—which, to repeat, is incompressible in the short run—carries with it the means of its own financing. The OPEC countries have no choice but to lend or invest the proceeds of their surplus in other countries. They are necessitous lenders. It follows that other countries must be borrowers. The financial counterpart to the OPEC surplus and the corresponding deficit of oil importing countries is a buildup of debts by the latter and an accumulation of financial claims by the former.

We should apply similar standards to both groups. It is fruitless to bemoan the apparent inability of debtors to repay debt if the creditors are not in a position to accept repayment. So long as OPEC is in surplus, it must lend and others must continue to borrow. What are the policy implications of this truism, or what I regard as a truism?

One is that maturities on loans to oil importing countries—developed or developing—ought to be long enough or renewable enough to conform to the time pattern of OPEC's balance-of-payments position.

The second policy implication is that if private financial intermediaries—banks and underwriters of securities—are unwilling to continue to lend in adequate amounts to oil importing countries, then official institutions ought to step in to supplement their activities. I urge the Congress to revive its interest in the OECD Financial Support Fund that was recommended 2 years ago.

The establishment of this fund would facilitate borrowing in financial markets by OECD countries. There is also a role for a special facility in the International Monetary Fund, a new oil facility, but I would propose it be financed in a different way.

The Fund has the power to issue securities. There is no reason why it cannot sell bonds in international markets—where OPEC countries are investing their surpluses—and lend the proceeds to oil importing countries.

In its lending, the Fund will have to continue to bear in mind the distinction made at the beginning of my statement. Some deficits are too large and need to be reduced. But a portion of the deficits of countries needing to borrow is inevitable. The policy conditions to which countries are made to conform before they are eligible for IMF loans ought to recognize this. Someone has to hold the hot potato.

Thank you.

[The prepared statement of Mr. Solomon follows:]

Prepared Statement of Robert Solomon [1]

Coping With Balance-of-Payments Surpluses and Deficits

I am pleased to have this opportunity to participate in the constructive efforts of the Joint Economic Committee to clarify the economic problems facing the United States and thereby to contribute to better policymaking.

In this interdependent world, we cannot look at the problems and prospects of an economy in isolation. We must take account of impulses from abroad and also of impacts of U.S. events and policies on the rest of the world, for our impact on the rest of the world has a feedback on our own economy. Furthermore it is necessary to view international problems in systemic or macroeconomic terms. The international economy is an interlocking, interacting system. Much of the confusion that exists about international economic problems stems from

[1] The views expressed in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution, its officers, trustees, or other staff members.

a failure to realize this and instead to try to cope with a difficulty without taking account of the repercussions on the rest of the system.

In a systemic way, let me examine the balance-of-payments problems of the countries—the OECD countries.

The international imbalances of the industrial countries (and also of the developing countries) have two components these days: a part that is adjustable and a part that must be accepted as unadjustable. The unadjustable part is a reflection of the fact that the OPEC countries have a surplus that is incompressible in the short run. If the 13 OPEC nations as a group have a current account surplus of about $45 billion, it follows inevitably that the rest of the world will have a current deficit." For the time being, the oil deficit is not correctible as long as the OPEC cartel holds together and in the absence of stringent measures to conserve oil. It has to be accepted and financed. But the aggregate $45 billion oil deficit can be distributed among the oil importing countries in various ways. It is well known that the recession in the industrial countries forced an extraordinarily large share of the deficit on developing countries in 1975. Even among the OECD countries, the inevitable oil deficit is badly distributed. Thus while the OECD nations as a group had a current account deficit of about $23 billion in 1976, Germany, Japan, and Switzerland each had a current account surplus of about $4 billion. This meant that a deficit of $35 billion had to be shared by the other 21 OECD countries. Of this $35 billion, the United Kingdom, France, and Italy together accounted for about $12 billion. The smaller OECD countries also had large deficits, aggregating about $14 billion.

If we focus on the balance of payments of an individual country—as the world has focused on Britain in recent months—it is not difficult to identify policy measures that should be taken to reduce the balance of payments deficit. What should not be forgotten is that such corrections have to occur in a system where the industrial countries as a group have an incompressible deficit corresponding to the OPEC surplus. If Britain and Italy and other countries adopt policies that seem to be called for when their economies are looked at in isolation, to which countries will their deficits be shifted? The developing countries and the smaller OECD countries have already been carrying too large a share of the aggregate oil deficit. Clearly, one has to expect Germany, Japan, and the United States, plus the Netherlands and Switzerland, to accept a larger share of the aggregate deficit if we expect the United Kingdom, Italy and other countries to reduce their deficits.

The oil deficit is a hot potato and someone has to hold it as long as the OPEC surplus remains so large.

Now it so happens that the countries with surpluses or disproportionally small deficits also have ample scope to expand their domestic economics. This is not completely a coincidence. The countries with strong balance-of-payments positions have expanded domestic demand too slowly. This is true for Germany (where real GNP increased at an annual rate of only 2 percent in the second and third quarters of 1976), of Japan (where real GNP increased only 1.3 percent, annual rate, in the third quarter of 1976), for Switzerland (where real GNP was virtually unchanged in 1976 though the volume of its exports increased 10 percent); and it is true for the United States, where real GNP expansion slowed after the first quarter of 1976.

It is now commonplace to recommend that Germany, Japan, and the United States should take the lead in adopting domestic stimulative policies. This proposal was first put forward by a group of sixteen private economists from Europe, Japan, and North America, meeting at the Brookings Institution in early November.

In the United States, the Administration has proposed a stimulative program. It appears that Japan will also move. Action by Germany is more uncertain. We all understand Germany's desire to avoid inflation. Yet today unemployment is high in Germany; employment actually fell in 1976. Without the strong increase in exports (more than 13 percent in real terms in 1976). Germany's unemployment rate would be much higher. With its open economy—and the possibility of suspending any remaining barriers to imports—Germany can count on a substantial increase in imports as it adopts more expansive domestic measures. Such an increase in imports would help to hold down inflation in Germany and would provide a much-needed lift to the other countries of Europe.

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Let me conclude with a word about international debt. What I have to say on this subject applies to developing as well as developed countries.

The OPEC surplus—which, to repeat, is incompressible in the short run—carries with it the means of its own financing. The OPEC countries have no choice but to lend or invest the proceeds of their surplus in other countries. They are necessitous lenders. It follows that other countries must be borrowers. The financial counterpart to the OPEC surplus and the corresponding deficit of oil importing countries is a build-up of debts by the latter and an accumulation of financial claims by the former.

We should apply similar standards to both groups. It is fruitless to bemoan the apparent inability of debtors to repay debt if the creditors are not in a position to accept repayment. So long as OPEC is in surplus, it must lend and others must continue to borrow. What are the policy implications of this truism? One is that maturities on loans to oil importing countries—developed or developing—ought to be long enough or renewable enough to conform to the time pattern of OPEC's balance of payments position.

The second policy implication is that if private financial intermediaries—banks and underwriters of securities—are unwilling to continue to lend in adequate amounts to oil importing countries, then official institutions ought to step in to supplement their activities. I urge the Congress to revive its interest in the OECD Financial Support Fund that was recommended two years ago. The establishment of this fund would facilitate borrowing in financial markets by OECD countries. There is a role for a special facility in the International Monetary Fund here. The Fund has the power to issue securities. There is no reason why it cannot sell bonds in international markets—where OPEC countries are investing their surpluses—and lend the proceeds to oil importing countries.

In its lending, the Fund will have to continue to bear in mind the distinction made at the beginning of my statement. Some deficits are too large and need to be reduced. But a portion of the deficits of countries needing to borrow is inevitable. The policy conditions to which countries are made to conform before they are eligible for IMF loans ought to recognize this. Someone has to hold the hot potato.

Representative Reuss. Thank you, Mr. Solomon.

Let's start out with this question that the United States, Germany, and Japan ought to stimulate their economies to spread the global payments deficit around in a more appropriate manner. I think all three of you agree on that.

Mr. Solomon gets most specific. In fact, the Japanese, of whom I have been critical in the past, in the Fukuda budget, have done what seems to me a pretty good job of stimulating their economy. They are improving their sanitation mass transit systems.

Then let's turn to West Germany. It is the two capitalist free countries, Japan and the United States, which have taken the lead. The socialist country, Germany, so far has not done very much.

It won't do, I think, in lecturing the Germans, to talk in Keynesian terms and say that you to have such and such a deficit.

I think the friends of the Federal Republic have to do some research and discover things that need to be done in Germany, just as I felt perfectly all right in telling the Japanese that they ought to get going on environmental and transportation measures and on housing.

So, there ought to be something to tell the Germans better than, "Why don't you run a bigger budget deficit, and that presumedly will stimulate activity and cause you to import more."

There has to be something better than that, and I bet you have it, Mr. Solomon.

Mr. SOLOMON. I don't have the details, Mr. Chairman, but in the tripartite meeting last autumn, attended by two Germans, among other Europeans, they focused on the infrastructure needs in Geramny, the social capital. I don't know the details of it, but they could come forward with a list of expenditure items in the public sector that have been neglected in the past.

Representative REUSS. Housing, I expect.

Mr. SOLOMON. If that is in the public sector. I think they also had other public sector items in mind.

Representative REUSS. Housing is in the public sector in Germany.

Mr. SOLOMON. Yes, it is—railroads, and I don't know what else is on the list.

Representative REUSS. I think it would be helpful if you, Mr. Solomon, and Mr. Klein and Mr. Friedman, if you have any insights into this, it would be helpful if you could file with us some ingenious suggestion.

I think it's a good idea for the strong countries to give each other friendly advice, and if you give advice, you might as well be reasonably specific.

Mr. Klein, you made the point, as many economists do nowadays, that the cold weather and all the numbing hardship which has come in its train in and of itself requires stimulus.

Mr. KLEIN. I didn't exactly say that.

Representative REUSS. If you say that the stimulus program that is now before us is even more necessary because of cold, I have no trouble with that. But aren't we getting into a regime of fine tuning, so fine as to defy the human eye if every time the anchovies fail to show up off the coast of Peru, we are going to have to take national economic measures to compensate for that? We are going to look like an early Charlie Chaplain movie, and you will be glad you didn't join the administration.

Mr. KLEIN. I feel one must look at the current weather problems and gas shortage problems in order to judge where we are, and in reading statistics. Some people could look at the unemployment number of last week and say that things are getting better, and we don't need so much of a stimulus. I think that is the point that we are trying to set the current problems against, because the unemployment rate won't look so good in February.

I agree with your sentiment that we should not try to make economic policy follow every seasonal zig and zag and every weather zig and zag. The policy being discussed is really an anticyclical policy, not an antiweather policy, and I think one should expend relief on a highly targeted area that is in trouble as far as the weather is concerned but we ought to keep these two things separate.

Representative REUSS. Mr. Friedman, I liked what you said at the end of your paper about the need for a beefed-up form of lending centralized in the IMF for the shocks that are being produced by oil price increases and similar matters. I think there is a strong case for having the IMF do that—and I want to see whether you agree with me—because that is the business the IMF has been in for so long. They are good at country studies, across the board recommendations, and are doing it all the time.

My difficulty with the so-called safety net, the $25 billion proposal of a year or two ago, is that it would have been mobilized under the OECD—otherwise an estimable organization—but one that doesn't really have the country team expertise of the IMF.

Second, the focus of the $25 billion Financial Support Fund proposal was purely oil balance-of-payments considerations, whereas in my view, and I seek to find out whether you agree— the real focus ought to be across-the-board, what are the fiscal, monetary, energy conservation and import-export policies of a country that wants to borrow.

Mr. FRIEDMAN. Mr. Chairman, I would like to say that I surely agree with the idea that the view ought to be across the board. We have the OPEC price increase, and we think of defending against that type of thing, but we really don't know what we are defending against in the future. Therefore, I would like to see a strengthening of the entire system against unexpected shocks.

The only comment that I would make that may be a little different than yours is this: I think if it is done in the Fund, then when we are dealing with the poorer developing countries we should recognize that such countries are normally in a chronic balance-of-payments deficit. They find it very difficult to recover from a shock to the extent of then creating what might be considered surpluses necessary to repurchase from the Fund.

I think we are seeing this now with the oil situation. I think in the next few years we are going to have a problem that the poorest countries will have to repurchase from the Fund. The Fund took a step in this direction in the so-called extended facility, in which they tried to lengthen the maturity periods for some countries, which I believe was a step in the right direction. But, I do think if the Fund is given this task, they must, in approaching the poorest and poor developing countries, be development oriented as well as balance-of-payment oriented. This means that the maturities, as well as the economic policy conditions that are attached to such funds must be related to the kind of expectations you can expect in the balance-of-payments behavior in such countries.

If I may say, that is what I thought I heard Bob Solomon also say when he talked about terms of renewals. Renewal is one way of extending the term.

Representative REUSS. I want to return to Mr. Solomon in a moment, but I first want to hear your views.

I would agree with you that the IMF, that is, the body to which this is handed, should perhaps set up a separate window and be more development minded and less immediate balance-of-payments minded. There is no reason it couldn't do this.

My real question is, if there is an oil safety net, who should administer it? Should it be the IMF, the World Bank family, or the OECD? My preference would be, first, the IMF, second best, the World Bank family, and the third best, OECD.

I have nothing against the OECD, but they really have not been in this business before.

Mr. FRIEDMAN. This is a strong institutional bias on my part, but I think that this kind of thing should be administered jointly by the IMF and the World Bank, and I think between them they have this combined view and this combined competency. They have these both on the monetary balance-of-payments adjustment side, which is the Fund's strong point and the development side, which is the World Bank's strong point. I think that when we were discussing the supplementary finance proposals in the late 1960's, the Germans came up with the idea of a Joint Committee of the Fund and the Bank to administer this kind of thing. I personally at that time felt it made sense, and I still do.

Representative REUSS. Yes.

Now, Mr. Solomon.

Mr. SOLOMON. Could I say a word on that question, Mr. Chairman?

Representative REUSS. Yes, and particularly because you did in your paper express yourself somewhat favorably toward the OECD.

Mr. SOLOMON. I want to make a distinction there, if I may. It seems to me one doesn't have to choose between the IMF and the World Bank on the one hand and the OECD safety net on the other. One can distinguish between the functions of those two proposals, as I do. The OECD safety net proposals is not expected to be used. It is a backstop that would make it easier for OECD countries to go out in the market and borrow on their own, whereas the combined IMF-World Bank proposal that you have just been discussing with Mr. Friedman is something that would be expected to be used. It is a means of financing deficits that are inevitable for years to come and for developing countries for many years to come, but it is a deficit enlarged by the fact that there is an OPEC surplus.

Can you accept the distinction I am trying to make? Under the IMF proposal, the IMF one would administer it, with all the expertise it has that you refer to, because it would be an active lending institution.

The OECD financial safety net would sit there as a guarantee, as it were, which people in the market would know exists and therefore would be readier to buy securities issued by Denmark or Finland or what have you.

Representative REUSS. Well, if you are still talking about an additional window, and we are getting to look almost like Versailles now, why not put that additional window in the IMF-World Bank? After all, the World Bank has been in the markets for years, and the OECD has not. If you want to assure the rich industrial countries that they have a guarantee, I would think the IMF/World Bank would be better than the OECD.

Mr. SOLOMON. What I am trying to do is not defend institutions, but distinguished between the two functions. I think there is a need for guarantee function which would be used by the developed countries primarily, but also some of the developing countries could use it, and the actual lending function. If you want to put the guarantee in the Fund rather than the OECD, that seems to me to be a secondary question.

Representative REUSS. Fine.

Senator Proxmire.

Senator PROXMIRE. I think you have Mr. Moorhead next. I came after him.

Representative MOORHEAD. Mr. Solomon, one very quick, small question, but we have all talked about the United States, Germany, and Japan stimulating their economies.

I think you pointed out that Switzerland was a country that had a $4 billion surplus, and no one has ever mentioned bringing Switzerland into this picture.

Is there a reason for this?

Mr. SOLOMON. Only because they are relatively small in the world economy, Mr. Moorhead. I think not only should Germany, Japan, and the United States be encouraged to expand, but a number of other countries are also in a position to adopt more stimulative policies. That includes Switzerland, as you say; it includes The Netherlands, probably Belgium, and there may be other countries as well.

They could all have more stimulative policies than they have had, particularly in a setting when it is being done by a group of countries.

Representative MOORHEAD. Thank you, sir.

Mr. Klein, in your testimony, you said that in your judgment, the amount of the stimulus package was just about right.

Mr. KLEIN. For the domestic policy package.

Representative MOORHEAD. For the what?

Mr. KLEIN. For our domestic policy package.

Representative MOORHEAD. Yes. Now, that package was determined upon before anybody had any conception of the severity, and I am going to talk about the economic severity of the cold weather of January–February. Would that in any way alter your thinking about the size of the package?

Mr. KLEIN. I would be opposed to thinking that the package should be expanded for that reason.

There are probably two offsetting factors. The newer economic statistics are a shade on the stronger side, or were before the feeling of the cold weather. The cold weather has more than offset it, of course, but I feel that policy will become too volatile and much too movable to change with the weather. I think it is up to the policymakers to state their case.

They should remain flexible, but they should stick by their positions and not move too much with each little disturbance, because we are going to have many more disturbances to come.

I think there should be definite relief programs for the areas that were very hard hit. That should not be put as part of the countercyclical package of about $15 billion or $16 billion a year.

Representative MOORHEAD. I would be interested, Mr. Klein, as to what form you see this assistance taking place in.

Mr. KLEIN. I would say certainly that places that have had complete snowbound traffic should have clearance assistance, and supplies taken in. I would say that there certainly should be a diversion of natural gas facilities and fuel supplies with high priority to those areas in order to keep the industrial States more alive.

Afterward, there could be, when the weather changes, other kinds of stimulative help to make up for the losses in the month or so of bad weather.

Representative MOORHEAD. Now, you described three groups and their attitudes toward the stimulus. I think there is a subdivision of No. 3, and that is those that believe there should be some additional for the fiscal year 1977, but stick with the package in 1978, the $15.7 billion in 1978.

I realize that you don't agree with that decision, sir, but if you were forced to go along with it, in what form would you advocate that it take?

Mr. KLEIN. Well, I think that the public works side of the package is held fairly small, and I feel that one could draw from the shelf a little more liberally than has been done. That would have an immediate impact on the employment statistics.

Representative MOORHEAD. I know that many communites under the previous program had their applications in and were ready to go and were greatly disappointed when they could not get started.

Now, I would like to turn to Mr. Friedman, to your analysis of the LDC debt picture, and as I read your testimony you point out that the size of the debt has gone up considerably in the recent past three years, but you conclude that, as I read your testimony, that it is not too big for those countries, those LDC's with well-managed economies.

Is that the thrust of your testimony?

Mr. FRIEDMAN. Yes, Mr. Moorhead.

I think it basically is the thrust of the testimony, although I have tried to concentrate my briefer remarks on the private bank lending, because I think there has been more public and official concern about that than about the governmental lending. So many of my remarks, at least in the briefer statement, were addressed to that. I think that in the longer statement, I tried to deal with both sides. I think that is the basic thrust.

Representative MOORHEAD. In your longer statement, you give 10 rules for well-managed economies, and then you say the banks will be more selective in their lending, and presumedly will limit themselves to those countries that come pretty close to your 10 criteria of well-managed countries.

It seems to me that that leaves for the public sector the poorly managed economies, the countries with poorly managed economies, and that there it has to be by government, and you conclude that the share for multilateral is there, and you turn to a degree, as does Mr. Solomon, to the IMF.

This is where I really wonder if we really want to take an institution which is known for its soundness, which is looked to for keeping—well, except in short-term emergencies—is really looked to for keeping the industrial part of the world, their economies, in good shape which benefits the lesser countries, and puts them into a charitable business.

It seems to me that if we feel we are forced to aid those lesser-developed countries with badly managed economies, we should recognize that and put that function in an agency which is recognized as a soft window, a loan body such as the International Development Association, or one of the soft windows of the regional banks.

Could you comment on that?

Mr. FRIEDMAN. First, I guess I should say that when I speak of the World Bank, I am really speaking of the World Bank Group. Therefore, for me, the World Bank is a combination of the World Bank as such, and the International Development Association, which, of course, you are all well aware of, as well as the International Finance Corporation.

I feel that the point about economic management if I may say, should not be any single creation isolated by itself. For a private bank, economic management is a very important criterion, but it is a combination of many things like having a strong export performance, for example, or having a debt-servicing record with respect to private banks.

Now, I would say, my personal view, is that good economic management as judged by the criteria for a developing country, is whether it has a sound development program and is implementing it. This would guide official agencies as well as private banks.

I believe that such criteria are guiding the development agencies, be they the World Bank or IMF or the Asian Development Bank or any development bank. The funds they lend have been entrusted to them for accelerating the development process. But the criteria will not be identical with those of a private bank, which has to be concerned with repayment over a relatively short period of time.

I really haven't addressed myself to that group of countries concerning which you would just say that they are poorly managed countries and that all their ills flow from poor management.

In the shorter presentation, I tried to point out that, for example, in the suggestion of the supplementary finance, that it was related to having sound development programs which had been reviewed by the international community.

Now, this, as I say, is addressing itself to the multi-national agencies, which I regard as trustees for international funds which have been given to them, be it the Fund, or the World Bank or the regional development banks, to insure that the maximum return—both for the individual country and the international community as a whole—is secured.

Representative MOORHEAD. There is division that has been set up in the World Bank family, and we have clearly said that the International Development Association is given much more latitude. Therefore, we don't expect them to put bankable loans. When we vote the money, we know it is going to be for high-risk propositions, and I can think of—though I won't name them—a number of countries that I don't believe have qualified for any 1 of the 10 criteria you have for good management, and yet, I can see that for humanitarian reasons, and with the idea of encouraging them with the hope that some development loan will set them on the path of righteousness, that IDA, as a high-risk member of the family, could properly act, but I still think the World Bank and the IMF have not been separated from the really high-risk situation.

Mr. FRIEDMAN. Congressman, I would like to say that my conviction is that the funds which are entrusted to the IDA are as well used as the funds that are entrusted to the World Bank. The difference is that you are extending funds to countries where the balance-of-payments outlook is such that you do not want to increase their debt servicing burden by borrowing from the World Bank, and therefore, much longer maturities and much more generous costs attached to such funds.

But regarding the usage of such funds, the same high standards are applied as in the World Bank. What we are talking about is the difference between countries which have a very long period to go before you can assume that they can undertake the burden of repaying debt, as against countries which can undertake to pay debt back in shorter periods. The private bank would have to assume that you have to pay back debt in a relatively short period of time.

Representative MOORHEAD. What I am saying is that that situation is perfect for IDA, but is not for IMF, in my judgment.

Mr. FRIEDMAN. I completely agree with you.

Representative MOORHEAD. Thank you.

Mr. Klein, you testified that the floating exchange rate was working very well, but you recommended upper valuation of the Japanese yen and the German mark.

Is that consistent with the good working of the floating exchange rate? Shouldn't that take place automatically if the floating exchange rate is working?

Mr. KLEIN. It is a managed float, of course, and when I make a calculation, or calculations, on the contribution to world recovery and contributions to the solution of the imbalance problems in countries that are having the most difficulty, I find there is a gain from this overall stimulus package that is being recommended for the stronger countries, but there is a much better gain, not so much on the growth account as on trade account, if the two strongest countries, and perhaps even this country, would allow our currencies to float upward a little more.

That, I think, would make a much stronger and quicker contribution toward wiping out some of the imbalances. It would just be another way of doing what Bob Solomon is suggesting, that is, sharing the petrol deficit.

Representative MOORHEAD. Thank you, sir.

Representative REUSS. Senator Proxmire.

Senator PROXMIRE. Mr. Klein, last Friday, the BLS indicated that there had been a drop in the aggregate number of hours worked, from 113 to 112, a very sharp drop, indicating a drop in production from December to January.

I understand that production is usually computed to some extent from that aggregate.

It indicated a slowdown, and those figures predated the most serious curtailment of production because of the slowdown in late January, so that apparently the situation has been somewhat aggravated.

Do you have any estimate at all of what you expect the growth rate to be in the first quarter of 1977?

Mr. KLEIN. Well, it is very difficult to adjust for this situation. I would say that we have less to go on by way of the precedent for this, but my own estimate for the Wharton group is that the first quarter GNP is going to be around 5 percent when we average January, February, and March, and make the compound interest calculations for an annualized rate.

Now, I would say that the weather impact is certainly shaving off a point certainly, and I think that the kind of statistics that you cite will show up in the February unemployment rate, also in hours worked per week.

One way of looking at this situation is to say that it is in the order of magnitude of a large strike in its impact, bigger than the

Ford Motor Co. strike. If one figures at the peak point, there were between 1 and 2 million people unemployed.

Senator PROXMIRE. There are so many increments involved here, the higher fuel prices and the higher costs because of the greater use of fuel, and because consumers have less money to spend in other areas. People are also working lesser hours and are paid less. Number three, some have been laid off entirely and didn't work at all during this period, and I think it was 1.8 million during part of the period at least.

Then you have the disturbing report in the Wall Street Journal this morning, which says that it appears likely that consumer spending will remain somewhat sluggish for some months. Lost wages because of plant shutdowns is eating into purchasing power. That is accompanied by a blow to confidence in many workers not knowing whether they will have a job to go to, or a warm home to go to at night.

It says that fear of inflation will tend to hold down purchases of automobiles and other items even after the cold weather damage has passed.

Do you put much stock in that?

Mr. KLEIN. That is a good journalistic account and I think it is highly dramatized. That is a very impressionistic statement, and there is very little to go on, very little basis for saying that consumers are going to become bearish suddenly. We have reports about the consumer credit for December, which was very bullish. People are going to come around toward spending again.

The consumer survey specialists are not going to be able to detect this swing in just a few weeks' time. So there is no scientific basis for saying that this is going to have enormous impact. This economy has very strong recuperative powers. When the weather changes, I think we are going to see something different in February and March.

Senator PROXMIRE. Did your estimate take into account the national gas shortage causing factory slow-downs right through March?

Mr. KLEIN. No. My estimate was based on one solid month of bad weather. It didn't start the first of January, but I figured for the first quarter, that at the worst it would be, say, a full 30 days. One could make that 6 weeks, and I think that is about as far as we should go.

Senator PROXMIRE. Let me go on the other side of this a little bit. It seems to me that the clearest and surest effect of the cold snap is to cut production. There is no question that this is going to happen.

Now, with supply reduced because production is cut, if we pursue a policy of increasing demand by more than we would have otherwise, that is, by increasing a stimulus package of $31 billion for 2 years and increasing it during this period, would that suggest that if the $31 billion is about right, given the supply conditions that we had when it was put together in December, that it might be inflationary, given the supply conditions in which we were producing less?

At least that is one logical question that has been asked. I would like to get your reaction to that concern.

Mr. KLEIN. Well, as I said before, I don't want to recommend increasing the stimulus because of weather, but the other part of the question is whether, if it were in fact done, would it be inflationary because of the order of magnitude, and I would say that I don't regard $15 billion in a package as inflationary under today's conditions. I don't regard $20 billion as necessarily inflationary.

Senator PROXMIRE. You think there is enough leeway here so if you had $20 billion in the first year stimulative package, it wouldn't be inflationary either.

I would like to ask Mr. Solomon and Mr. Friedman about another matter.

Mr. Friedman, you work for Citibank, which is certainly a marvelous, efficient organization and has led the way in all kinds of ways, but they have also gotten into an area that concerns me very much—external exposure of American banks, offshore lending by branches of U.S. banks, and by their home offices, is now more than $250 billion, I understand, or roughly one-fifth of the total bank claims.

Now, we are also all aware now, especially the three of us, who all serve in the banking committees in the House or the Senate, we are aware of the fact that we have had an increase in the number of problem banks, and our big banks particularly, all of our banks are very thinly capitalized, and I think they are undercapitalized.

Take a rule of thumb of 8 percent of deposits on the amount of capital you have, but the big banks in this country have about 5 percent or at least substantially below what it should be.

They are now getting into offshore lending, much of it in underdeveloped countries, and you indicate the very serious problems involved here. I am wondering if they are going a little far? Ordinarily, I wouldn't presume to question the great wisdom of our bankers, they are very wise and able men, but after all, they stumbled on REIT's, and they have missed before, and we have had serious bank failures in the last few years, and we have problem bank situations.

What about this situation of getting so very heavily involved? Are they doing too much, and going too far?

Mr. FRIEDMAN. Senator, I am talking about the developing countries, because a good deal of the offshore lending is actually to developed countries as well—but I assume you are addressing yourself really to lending to developing countries, rather than to the U.K. or France, or Denmark or Sweden, and countries of that kind.

Senator PROXMIRE. I am concerned with all of them, with the U.K. and Italy, but I am concerned about the others, too.

Mr. FRIEDMAN. I am talking about the developing countries separately.

I think the point that has to be always kept in mind is that the banks are very, very selective, as far as I can see, as to which of the developing countries qualify for private bank loans.

Now, here, I should make a point that is perhaps obvious, but it is a distinction that is important. We are talking about loans, and I am not talking about the normal self-liquidating trade financing, because that goes on with everybody all over the world. I am talking about a loan that says 1 year or more, as against a simple accommodation of international trade.

Now, the term loan is 1 year or more. In the term loans, there has been a very careful selective process. As I pointed out in my statement, I spoke of 20 out of 100 developing countries, but I think if you took 12, you could account for the great bulk of them.

So the question really comes down, when it is all said and done, to these countries. That is, as to whether or not they are the kind of countries which will be able to service their debts to private banks.

Now, I think if you take it country by country, my own judgment is that these countries can service their private debt. These are countries which have been characterized by very rapid export growth rates, they have been characterized by relativley high domestic growth rates and by a general strengthening of their economies.

Take, for example, a country that is much discussed, a country like Brazil, which is one of the very largest borrowers from the private banks. The fact is that in real terms the Brazilian economy has grown to become an economy 30 percent larger than it was in 1973. It has grown at a rate of 8 to 10 percent a year.

Senator PROXMIRE. But Brazil and all these countries seem to me to have an erratic and unstable situation from year to year. It is hard to know what is going to happen to coffee prices, and they seem to be moving in the direction of the way oil prices were handled.

But maybe not. Because of this erratic behavior in the past on the part of these countries, because they are particularly vulnerable to an increase in oil prices. I am just wondering if we don't have a situation in which the OPEC countries are really benefiting beautifully here. What they do is put their money in the safe haven of American banks. If a bank gets in trouble, the Federal Reserve is going to come along and bail them out. In the meantime, they are in a position to go ahead and increase oil prices without too much concern about what happens.

Can't we find a way of persuading, somehow, the OPEC countries to take more of the risk, to make the loans themselves to the LDC's. Isn't there a way to do it?

Mr. FRIEDMAN. The question poses a difficult problem. I would personally endorse your point that more and more should be done by the OPEC surplus countries.

Of course, we have to recognize that the number of OPEC surplus countries is being reduced. I think this is one of the problems of aggregation. The numbers look very big, but the numbers of countries that contribute to the surplus are becoming smaller and smaller.

What we are talking about is the Gulf countries, and Kuwait, Saudi Arabia, Nigeria, Venezuela, and to a lesser extent, maybe Libya. You are talking about a handful of countries and maybe fewer in the future. I personally believe that the efforts that were made in the past, as in the oil facilities, and also in the various development agencies that these countries have set up as well as the bilateral programs that they have undertaken to finance, should be greatly encouraged by the international community. These should be particularly addressed to the developing countries which have the oil import problem. I would surely support that kind of an effort.

Senator PROXMIRE. Could I ask you that, Mr. Solomon?

Mr. SOLOMON. I think it would be great, Mr. Chairman, if one could find the way to persuade the OPEC countries to lend directly to the developing countries.

Senator PROXMIRE. First, is there a problem with our banks becoming too involved with LDC loans?

Mr. SOLOMON. In my prepared statement, Senator, I did talk about this whole question of debt. As you realize, what the world consists of, really, is a handful of ultimate creditors, who have just been identified by Mr. Friedman and a large number of ultimate debtors, and the banking system and the various capital markets of the world, the Eurobond market and the New York market and the London capital market and others act as intermediaries between the ultimate creditors and the ultimate borrowers.

Now, in deciding how much you should worry about the position of the intermediaries, and that is what your question implies is exposure of the intermediaries, it seems to me you should not only look to the borrowers, as you were doing, buqt focus on the creditors, and ask yourself "when can those countries possibly receive repayment of their debt"? This is an economic matter. You can't——

Senator PROXMIRE. Well, focusing on those countries, I think they really have it. They put their money in Citibank, and they know it is 100 percent safe, even if Citibank should in some almost incredible happenstance have difficulties.

The Federal Reserve is not going to permit Citibank to go under. They are going to make sure everything is repaid. So the OPEC countries don't run any risk at all.

Mr. SOLOMON. They don't. That is your second question, and I will be glad to get to that: Can we somehow skip over the intermediaries so the ultimate lenders don't have it quite so comfortable?

But in the situation where we are using the intermediaries, and your first question referred to that, you are saying that the banks may get into trouble. You are saying that some of the borrowers may not be able to repay. That must be what you have in mind. What my prepared statement suggested, and what I would like to repeat, is that the terms of the loans to borrowers, particularly their maturities, ought to be matched to the terms of the balance of payments positions of the ultimate creditors, the OPEC countries.

As long as the OPEC countries are in surplus, Senator, they cannot be repaid by the the rest of the world. Therefore, it doesn't make much sense to focus on individual debtor countries and ask if they can repay. We simply have to tailor the terms to the time period when OPEC will move into deficit. That is a new concept, and it is a non-Euclidean way of looking at international finance. It seems to me it is the only sensible way to look at it.

Senator PROXMIRE. Let me ask you, Mr. Solomon, about a specific problem with respect to IMF.

The last administration has proposed that the United States consider a large $1.2 billion medium-term loan to Portugal, as part of a consortium package with several other industrialized countries, to help it meet its balance-of-payments problems. As reported in the press, this loan would be linked to the IMF's own standby program to that country. If an exception is being made to the stringency of Fund conditions in the case of Portugal to insure that it gets enough resources to protect the present government, will that weaken the effectiveness of the IMF in dealing with difficult stabilization problems with Italy, Great Britain, and France? Can the IMF remain depoliticized if it were to become involved supervising such a loan?

Mr. SOLOMON. Senator, I am happily out of the government, and I don't know much about this one. I would be surprised if the Fund had, in fact, waived its normal conditions. I would be very surprised indeed.

Senator PROXMIRE. I have been concerned about that Portugal loan, but you feel, based on the track record of the Fund, that you think it would be pretty well done.

Mr. Chairman, I just have one or two more questions that I would like to pursue if I could.

Mr. Solomon, since oil prices were quadrupled in 1973, commercial banks and other private intermediaries have assumed a larger burden of financing the deficits of developing countries. That is something I just brought out in my previous question to you and Mr. Friedman.

In the light of the growing debt burden of the growing countries that do not produce oil and the weaker industrialized nations, apprehensions have arisen about the willingness and ability of private intermediaries to continue to extend the level that they have extended. The activities of these intermediaries have provided to the point where they have provided nearly half of the oil financing deficits needed by the developing countries.

I have expressed alarm today, and I am sure Mr. Friedman and other responsible bankers are concerned, about this. What are the prospects for continuing financing in 1977 and 1978? Should the U.S. Government take any specific action to either bolster the developing countries' needs and backstop banks and other commercial lenders?

Mr. SOLOMON. I would have two answers to that, or two aspects to my answer to that question, Senator.

One would be that the United States, together with Germany, Japan, and other developed countries can help considerably by simply adopting more stimulative domestic programs, which are in the interests of the United States, Germany, and Japan in any event. The more rapid expansion in the industrial world will reduce the deficits in the developing countries.

So the problem to be dealt with would be smaller if those actions are taken. Between 1975 and 1976, the overall deficit of the developing countries fell by something like $10 billion, if I am not mistaken. The mere recovery that began has already had an effect in reducing the size of the problem, but nevertheless a problem remains, as your question implies.

My own suggestion would not be that the U.S. Government should backstop the commercial banks directly. I think the commercial banks can take care of themselves. What I would propose and have proposed in my statement is that a supplemental financing facility be established or reestablished in the International Monetary Fund to supplement the intermediary function of the private banks and securities markets, and that this special facility——

Senator PROXMIRE. We considered this in the Senate Banking Committee, and one of the problems was that the testimony indicated that one of the reasons that Saudi Arabia and the Emirate were more moderate, one of the things that restrained the countries from going higher than they did, was the concern about the effect of an increase in price over the developing countries.

If we make it easier for the underdeveloped countries to borrow to buy oil, then don't we eliminate an important restraint on OPEC price increases? OPEC is going to meet in another couple of months, they have said. Why shouldn't they then have a 25-percent increase in price, if we should come along in the meanwhile with a government facility to make sure no immediate damage is done?

Mr. SOLOMON. Senator, I understand the restraint differently than you did. I thought the restraint was that Saudi Arabia and the Emirates felt was that they did not want to hamper or retard recovery in industrial countries. They were afraid that would be set back.

Senator PROXMIRE. The concern was both.

Mr. SOLOMON. I have heard more about that than the concern about the developing countries, but they may have been concerned about that as well.

When the developed countries went into recession in 1975, the OPEC surplus fell. They felt the effect directly. Beyond that, some of the OPEC countries are worried about the political effects in Europe of a return to recession.

If that is the concern, then I am not sure that these proposals for supplementary financial facilities will in any way remove the constraint on Saudi Arabia and the Emirates to be moderate in their price policy.

Senator PROXMIRE. Thank you.

Thank you very much, Mr. Chairman.

Representative REUSS. Thank you.

Mr. Friedman, you were very much in on the consolidation of the various Zaire loans. You were hailed, and I hail you now for doing a very good job on that last September.

I have read somewhere that Zaire was very haphazard in incurring some of those earlier loans which got consolidated and extended under your aegis. The statement was made that the Zaire authorities were not sure how much they owed and to whom. Was it disorderly?

Mr. FRIEDMAN. I should say that it wasn't orderly, and, Mr. Chairman, I think that the situation was really that, as sometimes happened before, that the Government was in better command of the statistics of debts which it had extended, and was guaranteed not only by itself, but also by crediting agencies in the crediting countries.

In other words, it is an easy mechanism to check out, what you have borrowed from France if it was guaranteed by some agency, or the Export-Import Bank. You have statistics of the loan and on the other end.

Where the idea of the disorderliness came in, and I think it was disorderly, basically, to answer your question in a straightforward way, but they didn't have a foreign exchange budget. They didn't really have an orderly mechanism accounting for their foreign exchange receipts and for the allocation of their foreign exchange, some kind of a Government mechanism which would be called a foreign exchange budget, which is usually administered by the central bank. This was, I think, one of the reasons that they had the difficulties that they did, because expenditures and receipts of foreign exchange were not organized in a proper manner.

Representative REUSS. What sort of interest rates do these lower rated LDC loans from commercial banks command?

Mr. FRIEDMAN. The interest rates from private banks without the benefit of guarantees by institutions like the Export-Import Bank—the so-called spreads which have existed for borrowing countries in the Eurocurrency market, which is by far the largest single source of this kind of financing, are about over 1 percent to about 2, and now and then you hear about 2⅛ and 2¼. This contrasts with, say, the European countries which have borrowed recently on a so-called 1 percent spread, sometimes referred to as a spread of 100 basis points.

So the restraints on overseas borrowing range from about 1 to a little bit, a whisker over 2 percent. That is kind of a typical situation.

Representative REUSS. A few years ago, Eurodollar rates were very, very high, were they not? I think the amounts like 12 percent?

Mr. FRIEDMAN. That is right.

Representative REUSS. So the LDC's were paying 13 or 14 percent on some of those?

Mr. FRIEDMAN. That is right. They were paying rates, as in the case of all Eurocurrency transactions, above the prevailing deposit interest rates. The Eurocurrency market has followed the trend in the interest rates in the industrial countries, particularly the United States. So at the present time, the Eurocurrency rates are about the same as the equivalent rates in the United States.

When we had a couple of years ago interest rates in the United States of about 12 percent, then the Eurocurrency market was about 12½ percent, and on top of that you have a spread of, say, 2 percent, 1 or 2 percent above that, and they were borrowing at 13 or 14 percent, as you indicated.

Representative REUSS. A very large percentage of the lending of some banks, including your own, is offshore. That doesn't mean just LDC's, of course?

Mr. FRIEDMAN. That is right.

Representative REUSS. And I believe, doesn't something like 75 percent of the Citibank's profits come from offshore lending?

Mr. FRIEDMAN. Maybe not quite that much, but that is the general order of magnitude.

Representative REUSS. Something like that.

I just raise the question of public policy. It may not be in the best interests of this country if the banks—I don't say this has happened—but if banks lend to a lot of less developed country basket cases at very high interest rates, milk them for a few years and then the Federal Reserve or the International Monetary Fund or someone in the interests of world stability bails them out. I am not sure that the developing world would be better off. On balance, it might have been better either to have had a concessionary loan from the beginning, which might have saved the country from going down the chute, or perhaps no loan at all.

I am not talking about individual loans, and certainly not about individual banks, but isn't there a rule of reason somewhere floating around that ought to be brought down to earth?

Mr. FRIEDMAN. I think there is, Mr. Chairman, and I will make one or two comments on that, if I may.

One comment is that I think ought to be kept in mind is that there is very little fixed interest rate lending going on these days in the Eurocurrency market. So what is happening today is that the developing countries are profiting by the low interest rates. You had a very short period of time, really, when you had the high rates prevail. As these loans mature, and hopefully they are very short, many of these 12 percent loans have been renewed at lower interest rates. The borrower has come in for renewal of the credit and now he is paying 7 percent for a loan which a few years ago cost more.

We could have high interest rates again, but if they go up, they are like a yoyo. They go up and down, depending primarily on what happens to interest rates in the United States.

Now, I think my second comment is that the private banks are in the business on a very selective basis. I think that the private banks, in my own opinion, have gotten in the business without looking to the U.S. Government to be bailed out. They have to make decisions based on their own responsibility, on the assumption that the loans made will be repaid by the borrower, and within the framework of the economic situation of the borrowing country.

Now, I think this is what leads to a high degree of selectivity. So your most seriously affected borrowing countries have not been able to access the private banks, I think this is very important. That is one reason why I continue to be a strong supporter of official development assistance, particularly through the multilateral agencies. I don't expect the private banks to be dealing with the majority of developing countries, or even with anything but the relatively small minority in any substantial amounts.

It is rather typical that, if you measure on a per capita income basis, less than 1 percent of the loans made to the developing countries are found in the majority of the developing countries. When you total it up, what you find is that loans are in the countries that are in the relatively "higher income" group—income levels which by now are not all that low.

A country like Brazil or Mexico, or Algeria, is completely different, in a different world, from countries like India, Bangladesh or Pakistan. These countries only borrow from the private banks for self-liquidating, commercial transactions, or for very special kinds of transactions which total up to a very small fraction of totals. You know, it is less than 1 percent of the total portfolio of private bank loans to the developing world.

Representative REUSS. Thank you.

Just one short question of Mr. Klein about this year's fiscal stimulus. You have said in your statement that the program of approximately $15 billion of stimulus makes sense, and you also said that if the package were larger it would generate budget deficits for the near term in excess of those that we have seen in recent years and this, in your opinion, is to be avoided.

You also said in response to a question from Mr. Moorhead that a somewhat larger stimulus would not, in your judgment, create inflationary problems, I take it because there is excess capacity which you perceive in the economy.

Mr. KLEIN. That is right.

Representative REUSS. But you do, nevertheless, have aversion to increasing the deficit over the $15 billion per year projected?

Mr. KLEIN. It is a question of being consistent with a lot of statements that were made 2 or 3 months ago. I think it would be very embarrassing to cite the high deficits of the last couple of years as being fiscally irresponsible, and then turn up with that kind of deficit. It is a matter of political——

Representative REUSS. I think you have a point both with respect to the markets and with respect to what Mr. Solomon's former colleagues at the Federal Reserve might do if we go fiscally off the deep end, which I don't think we will.

Finally, to bring this down to real terms, the House Budget Committee, a few days ago, added something in excess of 10 percent to the fiscal 1977 budget deficit by virtue of $1.7 billion additional for public works.

Now, you have indicated, and I happen to agree, that public works can stand an extra amount of $1.7 billion. However, would it not be an act of prudence, since you say a $17 billion deficit will upset some people, whether rightly or wrongly, wouldn't it be a good idea if we recouped that $1.7 billion on the tax side by either not cutting taxes quite as much, or by plugging a little loophole or two, or having a cutoff on the $50 rebate? Wouldn't that do just about as much good from the macroeconomic standpoint and avoid some of these repercussions from the Federal Reserve, which may then feel that they have been called once again to tighten money?

Mr. KLEIN. In judging macroeconomic impact, we may be trying to manicure too much to differentiate those, but my preference would be for your change in the package, to make an inroad into the tax concession, and beef up the public works aspect.

Representative REUSS. I am glad to hear you say that. I was thinking, if my thoughts continue in the direction they are heading, in terms of an amendment to the Budget resolution when it comes up 1 week from tomorrow, that would approve the additional spending on public works, but cut down the tax reduction by an equivalent $1.7 billion so that it is a wash, does that seem sensible?

Mr. KLEIN. Yes, and the public works show up immediately in jobs. The payout period will necessarily be stretched out. So the GNP effect and the jobs effect may be somewhat different, but I don't think that is a bad point. I think the immediate appearance of improvement in the job statistics is all to be desired.

Representative REUSS. Thank you very much.

Senator Javits.

Senator JAVITS. I didn't get that last. Your words trailed off.

Mr. KLEIN. Yes. It takes time to spend the total amount of money in the public works field, so the total wage payments and total contribution to the gross national product may be stretched out over some period of time.

On the other hand, people are put to work right away on the public works projects. So the unemployment statistics may look better at an earlier stage and the GNP statistics better at a later stage.

Senator JAVITS. Are they put to work right away? That is the big argument, that there is time needed for preparation of public works, the bidding and the contracting and the legal things. It is often competitive, and that takes a very long time. The projects come along when the recovery is well underway and it doesn't mean anything. If anything, it may add to inflation.

Mr. KLEIN. I am speaking of a relatively small incremental measure, and I am thinking in terms of public works that are already on the shelf that have some of that spade work done. I would agree that on a massive scale there would be a slowing up process if you had to do those things, but it is my understanding that the shelf is not all that bad.

Senator JAVITS. Mr. Klein, I had in mind to ask you what part of the tax package you would—well, take this $1.7 billion. You would take it off the rebate, or off the permanent reduction?

Mr. KLEIN. I would take it off the permanent reduction, simply because the arithmetic of the rebate is easy, and everyone understands the $50, although it could be $45 instead of $50. The advantage of the rebate is that it keeps flexibility as regards future years and future programs intact. I would prefer to see it come off the permanent part rather than off the rebate part.

Senator JAVITS. Yesterday, we had Mr. Heller who also takes the same position that you do on the rebate, and we asked him about a chart which is in the Congressional Record prepared by the Library of Congress which shows the tax rate cuts had regularly produced more revenue by far than they had lost by virtue of a cut.

What would be your answer to that as bearing on whether we ought to cut rates or give a rebate?

Mr. KLEIN. The numbers are quite correct, that when rates are cut, it does indeed stimulate the economy, and to a point where tax receipts very soon are higher than they were.

I don't regard this present stimulus as being a fundamental attack on the deficit problem in the longer run. The stimulus is something we need because of the summer slowdown. It is something that is a bit unexpected; it is needed partly for those international reasons that we have been discussing this morning, and partly to get our own economy better—on a better growth path. It should not be looked upon as the ultimate thrust of economic policy in the years to come, and its contribution to the very basic deficit problem is likely to be very small compared to what may come in the next 2 or 3 years.

Senator JAVITS. Is there any reason why, circa 1977, we should take this course as against the rate-cutting course? In other words, is there anything in the contemporaneous frame of reference that dictates rebate versus rate reduction?

Mr. KLEIN. Not really. I think there is something to be said for temporary versus permanent measures. The only reason for the rebate, put in the form as it is, as far as economics is concerned, is it simplicity; $50 is an easy number to calculate, and to understand. But there is no particular reason for going that direction rather than in others.

Senator JAVITS. Well, what worries me is that we may be going over too far on the side of both simplicity and so forth, and perhaps foregoing an opportunity to do something with the money, especially as it is likely to be borrowed, but that is a battle we will fight out in the Congress.

But I do have your reasons, and I am grateful to you.

If you gentlemen would bear with me, I would like to ask a few questions on the fundamental issue of international economic policy which you were discussing here.

I would like to ask each of you to tell me this from your own vantage point.

Here we are faced with a $64 billion estimated deficit of the Western World to the OPEC countries, and I know there are various papers, and I have to be at another hearing on the reorganization bill, but you have various stratagems for getting over it. Can we get over it?

Is it simply such a hard nut that the world cannot swallow it? That goes for the developed countries. You speak, for example, or Mr. Solomon speaks in his statement, of the safety net of $25 billion, and speaks of it as a transition measure. But that would be transition from what to what? Is there any transition, or is this a permanent capital tax on the world, and hadn't we better find some way of using it as a pool of capital for world development, and if the Arab countries won't play, then we really have a really grave crisis in the world, because we can't make it this way, or do you gentlemen think we can?

Mr. Solomon.

Mr. SOLOMON. Senator, that hard nut you talk about, if it implies that OPEC is going to go on and on——

Senator JAVITS. I think it will go on now, the way we are dealing with the conservation of energy, unless President Carter can evangelize us the other way, and I hope and pray he can, and I want to help him all I can. It looks like it may go on for 10 years.

Mr. SOLOMON. It may go on for 10 years, yes. As long as OPEC has a surplus and lends it back to the rest of the world, and it does, because there is nothing else they can do, other than give it away, or spend it. If OPEC spends it, it no longer has a surplus. If OPEC has a surplus, and lends it back, it is not a tax.

To the extent that OPEC has a surplus, it is not exacting a tax from the rest of us in real terms. There are financial problems to be gotten over here. I believe, as I have from December of 1973 on, that these financial problems are manageable. They are serious, they require imaginative innovation, but I find it difficult to say this is something we can't swallow. The world is not going to come to an end, the financial institutions are not going to collapse. This can be managed.

Senator JAVITS. Is it being managed now?

Mr. SOLOMON. The financing up to now has been managed remarkably smoothly, sir, yes.

Senator JAVITS. And you don't think it is cumulative with our own banks being exposed?

Mr. SOLOMON. We had discussion of this before you came in, and my impression is that Senator Proxmire was satisfied with the answers he got from Mr. Friedman on that question.

Senator JAVITS. Mr. Friedman.

Mr. FRIEDMAN. You pose a very real question. Without trying to repeat what Mr. Solomon has said, which I would largely agree with, my point is that oil price increases are like increases in any particular price, and are bound to have redistributive effects on income.

In other words, what we have done is to take the income out of the oil consumer, and through this relending process, it has gone to somebody else. So we have an equity kind of problem concerning what this means for individual consumers within a developed country who may be particularly hard hit. In addition, there is also an equity problem, as I see it, among the developing countries which are among the poor countries as to how they might handle it as compared to richer countries.

As I see what happens down the road, which I think is a very, very real question in the world today, the question becomes the following: What happens to all this financing as it gets bigger and bigger and bigger? You ask where does it all end?

My personal view on how it ends, is that your developing country is going to have access to bond markets, such as Venezuela does now. We may see in the next 5 years countries like Brazil and Mexico going long term in the market, rather than short term, spreading the burden over a longer period of time. I think more of that is going to happen.

But I think, more importantly, the scale of the world economy is changing all the time. If we have an expanding world economy, then the significance of the surplus originating from any kind of source, including the oil surplus, becomes increasingly small. So, for example, when you see the expansion of world trade that has taken place only in the last 3 years—and you see it on the export side—or if you see the expansion of the gross national products of countries that has taken place, it seems to me that this is what is going to happen. Over time, the things that look very large to us today in terms of how we absorb these amounts are becoming increasingly less significant in real terms. I am not even mentioning the problem of inflation deflating the debt in real terms but just the fact that the world economy grows in real terms.

So I personally place a great deal of emphasis on whether we have economic policies in the industrial countries which are over a period of time compatible with what I would call anti-inflationary policies, and whether we are going to have sustained growth rates over a period of time so that the industrial world grows significantly in real terms. I think we can have a sustained rate in the developing countries as high as in the 1960's and 1970's. That will bring with it a higher growth in terms of world trade. This is basically the way I see the problem handling itself. But also we should develop facilities that will enable us to handle the unexpected shocks of the future in a more deliberate way than we did in the past.

I think the improvisation shown in the last few years was remarkable. I grew up during the Great Depression, and I can't help remembering the widespread disaster that occurred. Many of our facilities in the last few years were improvised. I think it would have been better if they were in place in advance but they were not in place. But despite the effect of the oil price increase, and the world inflation, and special problems in food, we really came through this crisis with much less of a setback than one might have expected under these conditions. I think that, essentially, underneath it, these economies kept growing in real terms, their modernizations kept growing, and their efficiency kept improving and their export capacity kept improving.

Senator JAVITS. Thank you.

Mr. Klein.

Mr. KLEIN. You certainly posed a problem, Senator Javits, in a nutshell, but the kinds of things we have been talking about are ways of living with it. I would say, yes, we can live with it, but perhaps more than that, as Mr. Solomon suggested, there is trouble living with it. I think that the whole world business cycle movement of the last 2 or 3 years and some economies have been strongly influenced by it.

Mr. SOLOMON. I agree.

Mr. KLEIN. Looking at it from the point of view of the United States, it is a tax on the United States. From the world point of view, one might be able to argue differently, but I find that a convenient way to look at it.

Now, the kind of policies we have been talking about this morning are ways to adapt to it. We can go on with that, but they are not fundamental. As you have said, conservation is the issue, or, more broadly, the way to attack this problem is through an energy policy. If we accept OPEC as an enduring institution, then these foreign trade, international finance and other policies are ways of coping with it, but the only fundamental attack has to be through an energy policy, and we have to enlarge the scope of our discussion.

Finally, I would like to say that that is the issue, and a very big issue. But there are other very major issues on the international fronts that are not quite part of the OPEC issue.

That is to say, suppose that the United Kingdom does reach the degree of self-sufficiency that they aspire to from the North Sea, say, by the end of the decade or thereabouts. They are still going to have problems in my opinion, problems of productivity, problems of balance of payments, and trade, not on the order of magnitude that they are having this year or last year, but there are still many to come.

So. the kinds of problems that we are looking at this morning must be analyzed from a point of view that is somewhat broader than simply the OPEC issue.

Senator JAVITS. Thank you.

Gentlemen, I would like to ask just one follow-up question before the hearing is adjourned.

Mr. Solomon, doesn't your remark assume that the lending is intelligent and economic, and instead isn't it unintelligent and uneconomic? Seven-day bank deposits are not economic. That is what is going on here. This is hardly an intelligent use of so large a pool of capital.

Now, what is your suggestion as to how we deal with that? Shouldn't the world better organize itself to talk turkey with OPEC, even while we are undergoing this strain? They are not living alone on this planet, and yet that is the way they behave.

Mr. SOLOMON. Senator, I don't want to be frivolous in responding to you, but if a large portion of the OPEC relending took the form of 7-day deposits, and in fact a decreasing proportion has been short term and an increasing proportion has been going into longer term instruments, but suppose they put all their funds in 7-day deposits and kept them there? The point is that they would have to keep them there. There is nothing else they could do with it, except spend it.

If OPEC chose to put all their funds in 7-day deposits, we borrowers from OPEC would benefit from their lack of intelligence. This would be an unintelligent loan policy by OPEC, and that would mean the interest costs to the rest of the world would be lower, and I don't know why you and I should worry about that.

Senator JAVITS. Turning to Mr. Friedman, your theory is that foreign trade provides a greater turnover of the oil money. Doesn't that mean that OPEC has to sit still to let this happen? If their price goes up and this is transmitted, as it must be—I don't know how they can avoid it—in all other commodities that oil buys and natural resources produce. Isn't that simply a slippery slope upward all the way?

Will this problem remain until we crack it by both conservation and an energy policy?

Mr. FRIEDMAN. Senator, I think you have given the answer I was just going to give. That is, I do think that if one has to assume that from time to time that the world economy, including the developed and the developing countries, is going to be confronted by huge increases in oil prices largely on a political basis, then any kind of a forecast about how you achieve equilibrium cannot possibly be accurate and it becomes difficult to comment rationally and intelligently.

I am assuming that oil prices would try to keep up, maybe, with world inflation, but not this extraordinary increase unrelated to economic events.

Now, I do think, however, that if you were suggesting at the end my own view of the OPEC problem, it is very similar to that which Professor Klein just outlined. It cannot be seen in itself, it cannot be seen as a problem of OPEC surpluses and OPEC's deficits. What you are talking about is how is the world economy going to adapt itself structually to these new prices of energy and oil. How are they going to reduce this dependence on a particular source?

This relates not only to energy, but will bring in problems of environmental control, urbanization, transportation, and so forth. We are talking of a major problem which I call structural development or economic development.

That kind of structural transformation is what one deals with all the time in the developing countries.

Senator JAVITS. Gentlemen, and I will say this to Mr. Klein, since his views have had a fine acceptance by the administration of his economic view, but it strikes me that that is a rare opportunity for a new President, just as Eisenhower could settle the Korean war on terms which would have impeached Truman, so I think President Carter can make an enormous contribution which will not be subject to the furies of the American people, like that the oil companies were hiding profits in their back pockets; and now the gas companies are. Maybe some of them are.

The United States has to be equal to massive conservation, but make Project Independence, or one like it, the only way to deal with this. The only way we are going to deal with this is by the enterprise and vigor of our country, and if it is not done, I think we are in for a very rough time, not only economically, and that is the least of it, but socially and politically, because the seed of discord happens everywhere, and the developing countries are really hanging on by their teeth, gentlemen. Unless we do something which is within our competence, I don't know that many of them can hang on, notwithstanding the reassurances of the Federal Reserve or the World Bank and the IMF that they are going to bail out our banks; $70 million is a lot of hay. This worry I share with you.

Are there any other statements that you gentlemen would like to make?

If not, the committee will recess until tomorrow.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 9, 1977.]

THE 1977 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 9, 1977

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 345, Cannon House Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling, Pike, and Heckler; and Senators Proxmire and Javits.

Also present: John R. Stark, executive director; Louis C. Krauthoff II and Courtenay M. Slater, assistant directors; William R. Buechner, William A. Cox, Kent H. Hughes, Sarah Jackson, John R. Karlik, and L. Douglas Lee, professional staff members; Michael J. Runde, administrative assistant; and Stephen J. Entin and George D. Krumbhaar, Jr., minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, CHAIRMAN

Representative BOLLING. The committee will be in order. Most of you are familiar with the fact that at hearings people come in late; and have a dreadful habit of starting more or less on time. We will proceed. During these continuing hearings on the President's Economic Report, we have heard from the President's Cabinet and other Government officials, from economists and in the academic community and private institutions.

Today we will hear from repersentatives of the business and labor community. Our opening speaker, Mr. Frank Lindsay, Chairman of the Itek Corporation and Chairman of the Research and Policy Committee of the Committee for Economic Development. Mr. Lindsay has had a particularly interesting business career including services as an executive assistant to Bernard Baruch. He has served on the boards of the National Planning Association and the Hudson Institute.

Our second speaker is Mr. E. D. Kuhns, assistant director of Research for the International Association of Machinists and Aerospace Workers. Prior to this, his labor background includes services with the Communications Workers of America, the Industrial Union Department of the AFL–CIO. He has a Ph. D. in economics and taught economics at the college level for a number of years.

The third speaker is Mr. Donald V. Seibert, chairman of the board of the J.C. Penney Co. Mr. Seibert started in business as a salesman in the shoe department of Penney's Bradford, Pa., store in 1947, working from there to his present position in 1974. He served as a member of the Business Council of Washington, D.C. and on the executive committee of the National Retail Merchants Association.

Mr. Lindsay, you may proceed as you wish.

STATEMENT OF FRANKLIN A. LINDSAY, CHAIRMAN, RESEARCH AND POLICY COMMITTEE OF THE COMMITTEE FOR ECONOMIC DEVELOPMENT; AND CHAIRMAN OF THE BOARD, ITEK CORP., LEXINGTON, MASS.

Mr. LINDSAY. My name is Franklin Lindsay and I am chairman of the board of the Itek Corp. I appreciate the opportunity to appear here today in my capacity as chairman of the research and policy committee of the Committee for Economic Development, an organization of 200 business and educational leaders. Our committee has presented testimony at these annual hearings on the economy ever since they were initiated. We believe these hearings before the Joint Economic Committee have made a highly constructive contribution to economic understanding and decisionmaking.

I would like to depart a moment from my text to say that your own committe report issued last September was one of the first to correctly identify the present economic crisis and to outline the alternatives of public policy that are now being seriously considered. I think you are to be congratulated on that report.

Representative BOLLING. We thank you for that. We are very proud of our record from the beginning, really, in this kind of examination of realities. We appreciate that comment.

Mr. LINDSAY. I will proceed.

Our basic economic policy recommendations for the next 2 years were spelled out in the CED policy statement on "The Economy in 1977–78: Strategy for an Enduring Expansion" issued last December, I would like to submit that statement for the record.

I shall concentrate my remarks today on the implications that statement has for selected aspects of the economic policy proposals now before the Congress.

I will skip the second page of my prepared statement.

Representative BOLLING. The policy statement you mentioned and your prepared statement will be included in the record.

Mr. LINDSAY. Among the specific ingredients of the policy strategy that we believe is needed for sound expansion over the next several years are six that I would particularly like to emphasize:

First, public policy should aim at realtively vigorous economic growth over the next 2 years—not a sluggish one. A healthy rate of expansion, at a time when the economy is operating well below potential, is essential not only to create jobs but also to provide adequate incentives for investment to expand capacity and improve productivity. CED believes that growth in real GNP that averages in the neighborhood of 6 percent during much of the next 2 years is a realistic goal that will help reduce both unemployment and inflation over the long run.

Second, we believe that a moderate amount of fiscal stimulus is needed to place the economy securely on a reasonable growth path. Monetary policy should be designed to accommodate such stimulus. Although various economic indicators have recently started to show encouraging improvements, these are by themselves not likely to produce a sufficiently high growth rate. However, we must take care to distinguish short-term fiscal measures to stimulate demand and relieve hardship caused by the severe winter from those measures that are designed to expand production over the longer term. A sure way to rekindle inflation is to increase demand without insuring that supplies will be adequate to meet that demand.

Third, tax reductions for consumers should be an important part of the stimulus program. CED's Research and Policy Committee has a strong preference for making such reductions permanent. We believe that an assurance of permanence will do substantially more to strengthen consumer confidence and, in turn, to encourage increased capital investment than a one-time rebate or temporary reductions in withholding. We recognize the need to achieve prompt results and to reduce the size of future revenue drains may create a case for combining permanent cuts with some temporary tax reductions. However, I believe I reflect the views of our committee in saying that the tax reduction portion of the new administration's fiscal stimulus package ought to place greater weight on permanent reductions in personal taxes than it now does.

Fourth, growth and stabilization strategy must give greater weight to direct measures to encourage productive long-term investment. The long-term solution to overcoming inflation lies as much in increasing supply and improving productivity as in restraining excessive demand. I believe that the economic stimulus program should give substantial weight to promoting capital investment for the added capacity and increased productivity that are essential if we are to avoid future supply bottlenecks and minimize cost inflation.

As was well documented in Chairman Schultze's recent testimony before this committee, the expansion of investment spending in the current upturn has been much less vigorous than in earlier postwar recoveries. However, it is frequently argued that special incentives to investment are not needed at present, given the amount of currently under-used capacity. Those who take this view believe that increased investment should come almost entirely from stepped-up consumer demand. I agree that added fiscal stimulus to enlarge consumer spending is a vital prerequisite for more capital investment. But I disagree with the view that the lag in investment spending can be laid solely at the door of sluggish market demands.

Numerous other factors exist today that deter corporate boards from building new plants and modernizing existing equipment. Most striking, in this connection, is the very sharp rise in the cost of new facilities that has occurred in recent years and the high degree of uncertainty about the extent to which these costs—including those connected with environmental, safety and other regulations—will shoot up further in future years. Increases in capital costs have been particularly pronounced in the materials industry—the very industry where the possibility of future bottlenecks is particularly high.

What we are dealing with are near term decisions that business firms must make as to whether or not they should go ahead with substantial new investment programs that will extend over long periods in the future. If the stimulus package is to have an important impact on such decisions, it needs to provide meaningful incentives now on which business firms will be able to count for many years to come.

Moreover, if major new investments are delayed until demand approaches capacity limits, an upturn in authorizing construction of new plants will occur just at the time the economy will need the increased capacity and lower costs of these plants to counter a return of inflation. In many industries lead-times between decisions to build plants and the actual completion of these plants have increased substantially. Therefore, these expansions should be started now so that as demand returns to long-term growth trends, new capacity will be completed and available. If these additions and modernizations are deferred until full recovery has occurred, they will be taking additional resources out of the economy at a time when consumption demand is highest, and may thus contribute to inflation rather than counter it.

Two lines of policy are needed to increase fixed investment now: One must be to increase confidence in long term growth and stability, and the other to provide financial incentives to start projects now rather than deferring them until demand materializes.

Confidence will be enhanced by permanent tax cuts both for consumers and for business. Confidence will be enhanced by removing any fears of a return of wage and price controls. Confidence will be enhanced by a vigorous Government leadership in insuring that energy production and consumption will be brought into balance, in both the short run and the long run.

CED has issued three policy statements on energy during the last 3 years. We are now preparing a fourth statement which should be released this spring. This statement will place particular stress on ways of halting or reversing our still increasing dependence on foreign oil between now and 1985 through more effective use of present energy sources and by intelligent conservation. I expect that we will have specific proposals to make on this issue.

Finally, confidence can be strengthened by measures that will demonstrate the government's determination to control inflation over the life of these new plants. In my view, this confidence can be strengthened by modifications of present tax laws to allow companies the option of shortening depreciation periods. Other industrialized nations generally allow much shorter periods for depreciation than we do. This would allow firms to recover their investment in dollars more nearly equal in buying power to the dollars originally invested. It would not cause a permanent loss of tax revenues to the Government but would result in a more equitable sharing of the risks of inflation between Government and industry.

These confidence-building measures will also provide immediate financial incentives to increase investment. The administration's proposal to increase the investment tax credit from 10 percent to 12 percent would add a further incentive. But we believe that the credit needs to be made permanent if it is to be effective. I have less confidence that the alternate option of a business income tax credit equal to 4 percent of payroll tax payments, as proposed by the administration, will be effective in increasing employment or in increasing investment. It does not provide a direct incentive for investment, although it might be selected by some companies on the ground that it would provide them with a relatively greater overall tax reduction.

Monetary policy also has a major role in stimulating investment. The primary function of monetary policy should be to maintain an efficient capital market for the transfer of funds between savings and investment. But that function can only be performed well if Federal deficits do not swell total borrowing demands to inflationary levels. To the extent that the monetary managers are again forced to use high interest rates to control inflation, steady investment in real productive capacity will be severely impaired.

Fifth, at least as important as increased investment in plant and equipment is investment in people—truly our greatest national asset. Insofar as possible, short-term programs to stimulate employment should also provide long-term returns to the Nation and to the individuals involved by increasing their skills so that they can constructively contribute both to increased national growth and to the development of their own productive capacities. It would be a shame if programs designed to increase employment now simply resulted in creating jobs in which people were merely marking time rather than improving their own capacities for the future. Again, insofar as possible, these programs should expand skilled manpower in industries where past shortages have contributed heavily to cost escalation that has discouraged new plant construction.

Finally, while the program for immediate fiscal stimulus now under consideration is receiving the lion's share of attention in current discussions, major attention also needs to be paid to a wide range of structural improvement needed for the long term. The point cannot be emphasized too strongly that while these programs will be required for years to come, the need to get started on them is often immediate. The latest energy crisis provides an excellent example.

Time does not permit me to describe the many areas where structural improvements are urgent. CED has dealt with these in some detail in its earlier policy statements, most recently in the statements on "Fighting Inflation and Promoting Growth" and "Improving Productivity in State and Local Government." In addition to our study on Federal energy policy, we currently have ongoing studies on improving the long-term performance of the U.S. economy; increasing employment of the young, old, and disadvantaged; revitalizing our cities; and making Federal regulatory agencies more effective.

I will skip the next paragraph.

Moving to the bottom of the page. Major efforts must be made during these 2 years to start to reduce the so-called noninflationary unemployment rate by more vigorous measures both to reduce structural unemployment and to lessen longer term pressures toward cost inflation. To do this requires a strong commitment to stepped-up investment in human and physical capital and a major effort to improve the functioning of our economic system by greater reliance on private initiatives and competitive market incentives.

[The prepared statement of Mr. Lindsay, together with the CED policy statement entitled "The Economy in 1977–78: Strategy for an Enduring Expansion" follow:]

PREPARED STATEMENT OF FRANKLIN A. LINDSAY

My name is Franklin Lindsay and I am Chairman of the Board of the Itek Corporation. I appreciate the opportunity to appear here today in my capacity as Chairman of the Research and Policy Committee of the Committee for Economic Development (CED), an organization of 200 business and educational leaders. Our Committee has presented testimony at these annual hearings on the economy ever since they were initiated. We believe these hearings before the Joint Economic Committee have made a highly constructive contribution to economic understanding and decisionmaking.

Our basic economic policy recommendations for the next two years were spelled out in the CED policy statement on *The Economy in 1977–78: Strategy for an Enduring Expansion* issued last December. I would like to submit that statement for the record. I shall concentrate my remarks today on the implications that statement has for selected aspects of the economic policy proposals now before the Congress. Let me first point out what we consider to be the key elements of a sound economic strategy for 1977-78.

The overriding objective should be a steady economic expansion that is both enduring and noninflationary. Key in working toward this objective is the development of a long-term coherent strategy that will strengthen business and consumer confidence. The strategy should minimize unnecessary uncertainties about future policies and prospects and particularly fears of a reimposition of wage and price controls and fears about recurring energy shortages. At the same time, the strategy must be sufficiently flexible to allow prompt responses to unforeseen contingencies. It can, and must, attack unemployment and inflation simultaneously. It should provide assurances that short-term stimulative measures will not overshoot their mark but remain compatible with the longer run needs for efficient resources allocation, price stability, and budgetary discipline. The strategy should place major emphasis on the need for increased investment in productive capital—both human and physical. It must from the very start combine overall demand measures in the form of fiscal and monetary policies with a wide range of structural measures to minimize unemployment, reduce cost inflation, enlarge supplies, and cope effectively with the nation's energy and urban problems.

Among the specific ingredients of the policy strategy that we believe is needed for sound expansion over the next several years are six that I would particularly like to emphasize:

First, public policy should aim at relatively vigorous economic growth over the next two years—not a sluggish one. A healthy rate of expansion, at a time when the economy is operating well below potential, is essential not only to create jobs but also to provide productivity. CED believes that growth in real GNP that averages in the neighborhood of 6 percent during much of the next two years is a realistic goal that will help reduce both unemployment and inflation over the long run.

Second, we believe that a moderate amount of fiscal stimulus is needed to place the economy securely on a reasonable growth path. Monetary policy should be designed to accommodate such stimulus. Although various economic indicators have recently started to show encouraging improvements, at least until the onset of the cold wave, these improvements by themselves are not likely to produce a sufficiently high growth rate. However, we must take care to distinguish short-term fiscal measures to stimulate demand and relieve hardship caused by the severe winter from those measures that are designed to expand production over the longer term. A sure way to rekindle inflation is to increase demand without ensuring that supplies will be adequate to meet that demand.

Third, tax reductions for consumers should be an important part of the stimulus program. CED's Research and Policy Committee has a strong preference for making such reductions permanent. We believe that an assurance of permanence will do substantially more to strengthen consumer confidence and, in turn, to encourage increased capital investment than a one-time rebate or temporary reductions in withholding. We recognize the need to achieve prompt results and to reduce the size of future revenue drains may create a case for combining permanent cuts with some temporary tax reductions. However, I believe I reflect the views of our Committee in saying that the tax reduction portion of the new Administration's fiscal stimulus package ought to place greater weight on permanent reductions in personal taxes than it now does.

Fourth, growth and stabilization strategy must give greater weight to direct measures to encourage productive long-term investment. The long-term solution to overcoming inflation lies as much in increasing supply and improving productivity as in restraining excessive demand. I believe that the economic stimulus program should give substantial weight to promoting capital investment for the added capacity and increased productivity that are essential if we are to avoid future supply bottlenecks and minimize cost inflation.

As was well documented in Chairman Schultze's recent testimony before this Committee, the expansion of investment spending in the current upturn has been much less vigorous than in earlier postwar recoveries. However, it is frequently argued that special incentives to investment are not needed at present, given the amount of currently under-used capacity. Those who take this view believe that increased investment should come almost entirely from stepped-up consumer demand. I agree that added fiscal stimulus to enlarge consumer spending is a vital prerequisite for more capital investment. But I disagree with the view that the lag in investment spending can be laid solely at the door of sluggish market demands.

Numerous other factors exist today that deter corporate boards from building new plants and modernizing existing equipment. Most striking, in this connection, is the very sharp rise in the cost of new facilities that has occurred in recent years and the high degree of uncertainty about the extent to which these costs—including those connected with environmental, safety and other regulations—will shoot up further in future years. Increases in capital costs have been particularly pronounced in the materials industry—the very industry where the possibility of future bottlenecks is particularly high.

What we are dealing with are near-term decisions that business firms must make as to whether or not they should go ahead with substantial new investment programs that will extend over long periods in the future. If the stimulus package is to have an important impact on such decisions, it needs to provide meaningful incentives *now* on which business firms will be able to count for many years to come.

Moreover, if major new investments are delayed until demand approaches capacity limits, an upturn in authorizing construction of new plants will occur just at the time when the economy will need the increased capacity and lower costs of these plans to counter a return of inflation. In many industries lead-times between decisions to build plants and the actual completion of these plants have increased substantially. Therefore, these expansions should be started now so that as demand returns to long-term growth trends, new capacity will be completed and available. If these additions and modernizations are deferred until full recovery has occurred, they will be taking additional resources out of the economy at a time when consumption demand is highest, and may thus contribute to inflation rather than counter it.

Two lines of policy are needed to increase fixed investment now: one must be to increase confidence in long-term growth and stability, and the other to provide incentives to start projects now rather than deferring them until demand materializes.

Confidence will be enhanced by permanent tax cuts both for consumers and for business. Confidence will be enhanced by removing any fears of a return of wage and price controls. Confidence will be enhanced by a vigorous government leadership in ensuring that energy production and consumption will be brought into balance, in both the short run and the long run.

CED has issued three policy statements on energy during the last three years. We are now preparing a fourth statement which should be released this spring. This statement will place particular stress on ways of halting or reversing our still increasing dependence on foreign oil between now and 1985 through more effective use of present energy sources and by intelligent conservation. I expect that we will have specific proposals to make on this issue.

Finally, confidence can be strengthened by measures that will demonstrate the government's determination to control inflation over the life of these new plants. In my view, this confidence can be strengthened by modifications of present tax laws to allow companies the option of shortening depreciation periods. Other industrialized nations generally allow much shorter periods for depreciation than we do. This would allow firms to recover their investment in dollars more nearly equal in buying power to the dollars originally invested. It would not cause a permanent loss of tax revenues to the government but would result in a more equitable sharing of the risks of inflation between government and industry.

These confidence-building measures will also provide immediate financial incentives to increase investment. The Administration's proposal to increase the investment tax credit from 10 percent to 12 percent would add a further incentive. But we believe that this credit needs to be made permanent if it is to be effective. I have less confidence that the alternate option of a business income tax credit equal to 4 percent of payroll tax payments, as proposed by the Administration, will be effective in increasing employment or in increasing investment. It does not provide a direct incentive for investment although it might be selected by some companies on the ground that it would provide them with a relatively greater overall tax reduction.

Monetary policy also has a major role in stimulating investment. The primary function of monetary policy should be to maintain an efficient capital market for the transfer of funds between saving and investment. But that function can only be performed well if Federal deficits do not swell total borrowing demands to inflationary levels. To the extent that the monetary managers are again forced to use high interest rates to control inflation, steady investment in real productive capacity will be severely impaired.

Fifth, at least as important an increased investment in plant and equipment is investment in people—truly our greatest national asset. Insofar as possible, short-term programs to stimulate employment should also provide long-term returns to the nation and to the individuals involved by increasing their skills so that they can constructively contribute both to increased national growth and to the development of their own productive capacities. It would be a shame if programs designed to increase employment now simply resulted in creating jobs in which people were merely "marking time" rather than improving their own capacities for the future. Again, insofar as possible these programs should expand skilled manpower in industries where past shortages have contributed heavily to cost escalation that has discouraged new plant construction.

Sixth, while the program for immediate fiscal stimulus now under consideration is receiving the lion's share of attention in current discussions, major attention also needs to be paid to a wide range of structural improvements needed for the long term. The point cannot be emphasized too strongly that while these programs will be required for years to come, the need to get started on them is often immediate. The latest energy crisis provides an excellent example.

Time does not permit me to describe the many areas where structural improvements are urgent. CED has dealt with these in some detail in its earlier policy statements, most recently in the statements on *Fighting Inflation and Promoting Growth* and *Improving Productivity in State and Local Government.* In addition to our study on Federal energy policy, we currently have ongoing studies on improving the long-term performance of the U.S. economy; increasing employment of the young, old, and disadvantaged; revitalizing our cities; and making Federal regulatory agencies more effective.

Let me conclude by urging our policy makers not to set their sights too low either with respect to the need to reduce unemployment or the need to wind down inflation. The January 1977 Economic Report focuses considerable attention on what should be regarded as tht "lowest unemployment rate attainable, under the existing institutional structure, that will not result in accelerated inflation." But, quite apart from the fact that there are serious drawbacks in any analysis that seeks to describe the unemployment situation with a single number, it will not matter greatly over the next two years whether 4 percent unemployment or 5½ percent is regarded as the theoretical noninflationary unemployment rate. With virtually any of the programs now under consideration, it will clearly be very hard to bring the actual unemployment rate down even to 6 percent.

What does matter is that major efforts must be made during these two years to start to reduce this so-called noninflationary unemployment rate by more vigorous measures *both* to reduce structural unemployment and to lessen longer-term pressures toward cost inflation. To do this requires a strong commitment to stepped-up investment in human and physical capital and a major effort to improve the functioning of our economic systems by greater reliance on private initiatives and competitive market incentives.

The Economy in 1977-78:

Strategy for an Enduring Expansion

A Statement on National Policy
by the Research and Policy Committee
of the Committee for Economic Development

CED

December 1976

Responsibility for CED Statements on National Policy

The Committee for Economic Development is an independent research and educational organization of two hundred business executives and educators. CED is nonprofit, nonpartisan, and nonpolitical. Its purpose is to propose policies that will help to bring about steady economic growth at high employment and reasonably stable prices, increase productivity and living standards, provide greater and more equal opportunity for every citizen, and improve the quality of life for all. A more complete description of the objectives and organization of CED is to be found on page 22.

All CED policy recommendations must have the approval of the Research and Policy Committee, a group of trustees whose names are listed on these pages. This Committee is directed under the bylaws to "initiate studies into the principles of business policy and of public policy which will foster the full contribution by industry and commerce to the attainment and maintenance" of the objectives stated above. The bylaws emphasize that "all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group." The Committee is aided by a Research Advisory Board of leading

Research and Policy Committee

social scientists and by a small permanent professional staff.

The Research and Policy Committee is not attempting to pass judgment on any pending specific legislative proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

The Program Committee of the Research and Policy Committee served as the drafting committee for this report. The full Research and Policy Committee participated in drafting the findings and recommendations. Members of both committees have the right to vote to approve or disapprove the statement and to submit individual comments for publication.

Except for the members of the Research and Policy Committee and the Program Committee, the recommendations presented herein are not necessarily endorsed by other trustees or by the advisors, contributors, staff members, or others associated with CED. Contents approved effective December 9, 1976.

[1]/Voted to approve the policy statement but submitted memoranda of comment, reservation, or dissent or wished to be associated with memoranda of others. See pages 13 to 21.

[2]/Voted to disapprove this statement.

NOTE/A complete list of CED trustees and honorary trustees follows page 23. *Company or institutional associations are included for identification only; the organizations do not share in the responsibility borne by the individuals.*

Program Committee*
of the Research and Policy Committee

*This committee served as the drafting committee for this statement.

Participating Advisors

Project Director

FRANK W. SCHIFF
Vice President and Chief Economist
Committee for Economic Development

Staff Advisor

SEONG H. PARK

THE ECONOMY IN 1977-78: Strategy for an Enduring Expansion

No more urgent and important task awaits the new President and Congress than the establishment of policies that will foster determined progress toward sustainable high employment without inflation. The only dependable road to achieving this objective is through an orderly and enduring expansion.

Clearly, it will take time to develop detailed and workable programs for coping with the nation's long-term economic problems. But this Committee sees an urgent need to make clear the broad goals and directions of economic stabilization policies for 1977 and 1978. The American people need to be assured that the President, Congress, and all the government's economic policymaking bodies will pursue a coherent strategy for promoting healthy, noninflationary, and sustainable economic growth while simultaneously taking direct measures to attack special unemployment problems.

The strategy we recommend in this statement is derived from principles developed by CED's Research and Policy Committee over the past thirty years and most recently in our policy statement *Fighting Inflation and Promoting Growth.* We believe they provide a solid framework for shaping sound and practical economic stabilization policies.*

BUILDING CONFIDENCE

Business and consumer confidence is the key to restoring the economy to a steady upward course. Uncertainty about national economic policies and prospects has become a major factor inhibiting the spending and investment decisions and future plans of both business executives and consumers. We need strengthened consumer confidence to provide the markets required to bolster economic growth. And we badly need more investment in productive capacity in order to be able to generate the added jobs and products that the economy will call for in the years to come.

* See memoranda by EDWARD R. KANE and by J. W. VAN GORKOM, page 13.

*Confidence-building efforts deserve to be high on the priority list of the new administration and Congress. Assurance is needed, in particular, that short-term stabilization measures will be taken to foster an adequate recovery and that such measures will also be fully compatible with the longer-range objectives of stable prices and an adequate budget surplus at high employment.**

*We also believe that as a part of the effort required to dispel uncertainties, business and labor need assurance that they will not face the threat of wage and price controls. We therefore welcome the recent announcement by the President-elect that he will not seek standby authority to impose such controls. Even the anticipation of wage and price controls can seriously impair investment incentives, trigger precautionary price and wage increases, and lead to increased pressure for more extensive government involvement in market decisions.***

ATTACKING INFLATION AND UNEMPLOYMENT SIMULTANEOUSLY

Some uneven progress has been made in bringing down inflation and unemployment from their record levels of recent years, but both remain intolerably high. The cost in wasted resources, lagging productivity, social inequities, and economic distortions is more than the nation should be asked to endure. *We believe that the tasks of conquering inflation and achieving high employment are not mutually exclusive.**** *They can and must be attacked simultaneously and with the greatest possible determination, even though it must be recognized that success can come only gradually.*

A new layer of complexity has been added by the increasingly close linkage of the world's economies. An enduring economic expansion in the United States cannot take place without a sound world economic recovery. In turn, such a recovery is vitally dependent on a healthy domestic economy in the United States and also in the other major industrial nations. *We believe, therefore,*

* See memorandum by RALPH LAZARUS, page 14.
** See memoranda by ROBERT R. NATHAN, page 14, and by ROGER B. SMITH, page 16.
*** See memorandum by C. WREDE PETERSMEYER, page 16.

that the three strongest trading partners — the United States, West Germany, and Japan — need to take the lead in a concerted effort to shape harmonious policies that will promote enduring world economic expansion while assuring maximum freedom in international trade and financial transactions.

A major element in such an effort should be the achievement of a rate of expansion in real incomes and output that is vigorous enough to stimulate higher productivity growth and needed additions to capacity but not so rapid that it causes the economy to overheat. **This Committee believes that for the United States a rate of increase in real gross national product (GNP) that averages in the neighborhood of 6 percent during much of the next two years is a realistic growth target for making headway both in reducing unemployment and in winding down inflation. Fiscal and monetary policies should be geared to fostering such a growth rate.** Of course, as the economy moves closer to full utilization of resources, a slower growth rate will become appropriate.

According to most indicators, the nation's economic advance has slowed prematurely during the last half of 1976. Capital investment is not moving forward as vigorously as had been hoped, growth in industrial production has flattened, consumer buying has leveled out, and federal outlays have fallen short of budgeted totals. **To enable the economy to reach the recovery target cited, we believe further moderate stimulative action is required promptly to bolster demand.*** However, more information about the actual state of the economy and the prospective trend in government outlays will be needed before a clear decision can be made about the particular amount of stimulus required.

But improved demand management policies alone can move the economy only partway toward the simultaneous attainment of high employment and price stability. If the nation is to make satisfactory progress toward these goals, demand policies must be complemented by a wide range of structural measures, many of them pinpointed to the industrial, population, or geographic sectors where the problems of unemployment, low productivity, or capacity limitations are most serious. Such structural measures are as important as fiscal and monetary policies for achieving our economic goals.

* See memorandum by ROGER B. SMITH, page 16.

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KEY ELEMENTS OF A STRATEGY FOR ORDERLY EXPANSION

A sound strategy for fighting inflation, reducing unemployment, and promoting growth will have to include a number of elements. Some of these will have a prompt impact. Other key elements will yield their beneficial results only over a longer span of time but nonetheless deserve early attention.

Actions with a prompt impact*

1. The extra stimulus that the economy requires should as far as possible be provided by fiscal measures that can be instituted quickly, produce prompt results, and do not entail a significant long-term drain on the nation's fiscal resources.

2. As the principal method of injecting extra stimulus, we strongly favor broadly based tax reductions, both for consumers and for business. Our preference is for a permanent reduction rather than a temporary tax cut or a one-time tax rebate. The assurance of permanence, we believe, can do more to reduce uncertainties, instill confidence in the future, and thereby promote greater private spending.** If permanent reductions in tax rates are properly designed, they need not mean permanent revenue losses because they will generate substantially higher taxable incomes than would otherwise have been realized. Among the types of measures that deserve consideration in this connection are an increase in the personal exemption, an enlarged per capita tax credit, a rise in the investment tax credit to a permanently higher level, and improved depreciation allowances.[1]*** The size and timeliness of the initial impact of the tax change could be accentuated as much as needed by making the change effective as of January 1, 1977, and possibly even partially or fully applicable to 1976

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[1]Although these measures are permanent, their net drain on revenues should diminish as time passes: in the case of personal income tax cuts, as a result of the fact that rising money incomes will move taxpayers into higher brackets; in the case of lower business taxes, through the stimulative effect of the cuts on investment and, hence, on incomes and tax receipts. In determining the design of any permanent tax reductions, account must, of course, also be taken of the facts that a number of temporary reductions in personal taxes from 1974 levels are now in effect but are scheduled to expire at the end of 1977 and that the present 10 percent level of the investment tax credit is effective only through 1980.

* See memorandum by RALPH LAZARUS, page 17.
** See memorandum by JAMES Q. RIORDAN, page 17.
*** See memorandum by C. WREDE PETERSMEYER, page 18.

returns. At the same time, we recognize that there can be a case for combining more permanent tax cuts with temporary tax reductions or a rebate in order to hold down the size of future revenue drains and achieve prompter results.*

3. To minimize the danger of overdoing fiscal stimulus and to foster long-term budgetary discipline, budget and other fiscal policies should be developed within a multiyear framework. Restraint must be exercised in launching new federal programs with a potentially large inflationary impact. Any stimulative measures used for short-term stabilization purposes must not be allowed to overshoot their mark and cause excess demand inflation. Expenditure programs chosen to provide extra demand stimulus should generally be of a type that contains built-in safeguards to assure that the programs will be automatically phased out as high employment is approached. Nor do we believe that recent unintended shortfalls in government spending should be offset by a forced effort to spend extra federal funds in a hurry. Instead, extra expenditures should, as much as possible, be concentrated in carefully considered programs that represent productive investments in the country's material and human resources. With proper forethought, such programs can be kept largely temporary in nature and yet be productive in the longer term. Examples are programs to speed the improvement of deteriorated railway roadbeds or to provide the unemployed and underemployed with training in those skills that will be needed to sustain economic growth.**

4. Monetary policy should not be expected to substitute for a responsible fiscal policy; rather, it should be designed to accommodate a responsible fiscal policy. In general, we believe that the larger adjustments for stabilization should be accomplished through the tools of fiscal policy rather than monetary policy. We also believe that monetary policy, apart from accommodating the added fiscal stimulus we are recommending, has moved about as far toward ease as is productive under current circumstances.

Medium- and longer-range measures***

1. Responsible fiscal and monetary policies must be blended with a range of structural measures. These structural measures

* See memoranda by CHARLES KELLER, JR., and by ROBERT R. NATHAN, page 18.

** See memorandum by CHARLES KELLER, JR., page 20.

*** See memorandum by RALPH LAZARUS, page 20.

should, in particular, be designed to reduce especially high rates of unemployment within the inner cities and among the young, old, and disadvantaged and to strengthen incentives and remove harmful disincentives for engaging in productive work. A CED subcommittee is currently studying in detail constructive and innovative approaches toward increasing useful employment and training opportunities for these groups, particularly in the private sector. It is also vitally important to hold down cost inflation by promoting increased productivity and competitiveness in both product and labor markets and to encourage additions to productive capacity in the energy field and other areas in which the long-term needs for capacity growth are especially urgent.

2. Stabilization strategy must give greater weight to encouraging productive capital investment. The long-run solution to overcoming inflation lies as much in increasing supply as in restraining excessive demand. Past policies have given insufficient attention to supply and capacity problems. Only through adopting policies that promote more vigorous growth of capital investment can the nation be assured of the added industrial capacity and increased productivity that are required to avoid future supply bottlenecks and minimize cost inflation.

COPING WITH CONTINGENCIES

The strategy for assuring favorable economic growth must make provisions for the unexpected. But steps to deal with contingencies ought not to be adopted on an ad hoc and uncoordinated basis. They should be part of an integrated strategy for reconciling short-term stabilization needs with efficient longer-term resource allocation.

In this statement, we have placed particular stress on the near-term need to provide added demand stimulus to assure an adequate and lasting recovery. However, while dealing with the more immediate risk of flagging growth, policy makers must also remain alert to the danger that inflationary supply pressures may emerge in key sectors sooner than is now widely anticipated, either because there may be less capacity than has been estimated or because the overall rate of demand expansion might become more rapid than the one we have advocated.

There are also the risks that renewed inflationary shocks might be exerted on the U.S. economy through external influences or that upward cost-push pressures might become much more substantial than current trends suggest. The latter situation might develop if a pattern of relatively moderate average wage increases should give way to a widespread and aggressive push for large wage settlements. If such a combination of forces should impel a new wave of inflation, that unhappy event would need to be opposed by appropriate countermeasures.[2] We believe that a continuing mechanism for voluntary business-labor cooperation, such as a strengthened high-level national Labor-Management Committee, can do a good deal to foresee and forestall possible new inflationary pressures.

As general guiding principles for contingency planning, we recommend the following:

1. Deviations from a steady longer-term course should be adopted only if there is strong reason for making such a change.*

2. Once the need for providing significant extra demand stimulus or restraint is clearly established, flexible adjustments in both fiscal and monetary policies should be made promptly but within the discipline of a stable long-term growth strategy.

3. If government expenditure programs are chosen to provide some of the extra stimulus, they should generally contain mechanisms to ensure that the programs will be automatically phased out as high employment is approached.

4. Supply-demand and wage-price relationships in particular industries should be carefully monitored so that potential inflationary pressures stemming from such factors as materials and capacity shortages or industrial disputes can be anticipated at a sufficiently early date to permit timely efforts by the government and private firms to avert or ease such pressures.

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[2]For a detailed discussion of various measures to deal with inflation, see our 1976 policy statement, *Fighting Inflation and Promoting Growth.*

* See memorandum by ROGER B. SMITH, page 21.

CONCLUDING COMMENT

The policy strategy that we have outlined has two essential ingredients. First, it calls for early recognition of emerging problems and timely action to cope with these problems. In this connection, there is a major need for better information, including improved statistical measures more closely related to policy options.

Second, it emphasizes the importance of keeping short-, medium-, and long-run effects of current policies in proper perspective. Policy makers must remain constantly aware that the steps they adopt today will have wide repercussions whose precise nature and timing are often difficult to foresee. They need to retain a healthy understanding of the fact that in our complex and interdependent society, fostering a sound, noninflationary recovery remains an extraordinarily difficult task. At best, government policies can only encourage a healthy, noninflationary and broadly distributed economic expansion; they cannot guarantee it. What the American people can fairly ask is the best performance of which public policy is capable.

Memoranda of Comment, Reservation, or Dissent

Page 5, by EDWARD R. KANE

Although I am in substantial agreement with the statement, I do have a serious reservation about the target of 6 percent real increase in the nation's GNP for two additional years. This is higher than now seems within our grasp, and it would be inappropriate to adopt near-term stimulative measures to force such a growth rate over this period of time. Furthermore, this seems to conflict with the concluding statement that "policy makers must remain constantly aware that the steps they adopt today will have wide repercussions whose precise nature and timing are often difficult to foresee."

There is also, throughout the statement, a note of urgency about the various recommended actions. Although I agree that present problems call for some stimulus, I think it must be applied in an orderly fashion. The economy is basically sound, and the facts do not indicate the need for extreme or drastic action.

Page 5, by J. W. VAN GORKOM, *with which* R. HEATH LARRY *has asked to be associated*

I do not approve the publication of the policy statement. This statement offers the same broad, general platitudes that we have already presented in other releases. It adds nothing of practical significance to the subject under discussion. I see no reason to publish it.

Page 6 , *by* RALPH LAZARUS

I agree that confidence-building efforts ought to be high on the priority list of the new administration and Congress. Indeed, I would go farther and state that such efforts should have the highest priority.

The instability and fundamental weakness of business and consumer confidence derives principally from the experience of the last five years. During this period, economic growth has been subnormal and uneven, averaging less than 3 percent annually, while inflation has been excessive and continuing, averaging close to 7 percent annually.

If confidence is to be restored in any lasting fashion, equal emphasis must be given to policy actions that foster sustained economic growth and those that promote expectations that reasonable price stability will be attained. The statement, however, only partly addresses these priority needs. Numerous specific policy recommendations are made relative to stimulation of economic growth, but almost no specific or innovative policy recommendations are made relative to the amelioration of inflation.

Page 6 , *by* ROBERT R. NATHAN, *with which* FRAZAR B. WILDE *has asked to be associated*

For several years, even when the prospects of active or standby controls were virtually nonexistent, many large price increases were excused on the grounds of the so-called threat of controls. We do not need across-the-board wage and price controls, but we do need direct efforts to slow the rate of inflation and make perceptible progress toward price stability.

The "soft economy" approach has not brought us near to price stability. Despite nearly four years of slow growth and deep recession, we have not really made significant progress in lowering the rate of basic inflation. If we were to eliminate from our price indices the shock effects, direct and indirect, of the OPEC oil-price decisions and the 1972 Russian grain deal and the two devaluations, we must conclude that inflation in the second half of 1976 is only modestly lower than it has been for several years.

We must recognize that inflation will need to be fought simultaneously and vigorously along with determined pursuit of recovery and growth. The most serious deficiency in this generally excellent CED program is the failure to deal with the need for a positive and forceful anti-inflation effort. Such an effort may entail guidelines and guideposts; using the persuasion of executive authority in holding down price and cost increases; asking for legislating authority to delay sizable price and wage increases, pending public hearings; stimulating joint labor-management efforts to speed improvement in productivity; assuring investment incentives not only to speed modernization but also to lean toward excess capacity rather than tightness in capacity; and other measures that can flow from imaginative and serious efforts to pursue price stability. Even standby authority to impose controls is preferable to the "do nothing" pattern we have followed so unsuccessfully.

Finally, I would strongly urge a new Temporary National Economic Committee (TNEC) like the one headed in the 1930s by Senator Joseph O'Mahoney. That committee, in an objective and nonpartisan manner, did a remarkable job of analyzing the strengths and weaknesses of price and other forms of competition in most sectors of the economy. Today, with far better data and computer capabilities, we could analyze the functioning of the marketplace much more thoroughly and fruitfully than was possible forty years ago.

We desperately need to know why it is so difficult to get rid of inflation. We need to find ways to strengthen price competition in the marketplace and thereby preserve our free-enterprise system. This is certainly a major effort in which business and labor could and should cooperate with all the branches of government in pursuit of the common objective of high levels of employment and production along with price stability.

Page 6 , *by* ROGER B. SMITH

There is no question that assurance by the President of his opposition to wage and price controls would do much to restore confidence. In my view, however, much more is required. The vast expansion of the regulatory authority of government and the unending stream of administrative orders have materially increased both the cost and the risk of new investment. Growth in output and employment has been impaired. A clear declaration by the President of a moratorium on new regulation in order to assess the impact of existing regulation would represent a second essential step in restoring confidence.

Page 6 , *by* C. WREDE PETERSMEYER

Conquering inflation and achieving high employment may not be mutually exclusive, but if there has to be a choice, I believe conquering inflation must take priority. Any crash measures taken to solve unemployment that might possibly rekindle the fires of inflation would be self-defeating. The result would be more unemployment rather than less.

Page 7 , *by* ROGER B. SMITH

At present, there is a wide divergence of view on whether any additional so-called stimulus is required or is desirable. The federal deficit is currently estimated to be in the area of $50 billion. The short-run effect of "stimulus," however managed, would almost certainly increase this deficit and, along with this, inflationary expectations. Consumer prices are still rising at an annual rate of over 5 percent, a major improvement over the double-digit rates of the recent past but still too high. In my view, this paper does not give adequate attention to this continuing threat or its long-term implications.

Page 8 , *by* RALPH LAZARUS

Although I am substantially in agreement with the general substance of the four sections under this heading, section 2 would benefit from additional detailed description of the size and consequences of the extra stimulus recommended.

With regard to the consumer tax cut, an across-the-board permanent reduction of consumer income taxes of some $15 billion would not be inflationary and should be enacted promptly. Such action would be in preference to a one-time rebate, which experience has shown to have distorting effects and only temporary benefits to the growth of the economy. A permanent, equitable tax reduction would boost confidence, stimulate use of accumulated savings, and result in an acceleration of consumer spending greater than the amount of tax reduction. This growth in demand would, in turn, create a sustained increase in production that would support business confidence and encourage expansion of productive, job-creating capital investment.

Although some short-term revenue losses would occur, greater emphasis should be given to the fact that a permanent tax reduction would stimulate strong growth in overall economic activity, in employment, in aggregate consumer income, and in total corporate profits. Such growth would result in a broadly based expansion of the federal tax base that would eventually more than restore the revenue lost to the tax cut action.

Page 8 , *by* JAMES Q. RIORDAN

I agree that the economy needs fiscal and psychological stimulus. Early recognition of the fact that the private sector is overtaxed and overregulated will be very helpful, especially if prompt changes, albeit small, are made on a permanent and on an across-the-board basis. Both consumers and investors need reassurance. Changes should make our laws, especially our tax laws, simpler.

Page 8 , *by* C. WREDE PETERSMEYER

I would be hopeful that any tax reduction would truly be "broad-based" through the granting of a given percentage reduction in federal income tax liability for all taxpayers without a ceiling such as the $200 in the Tax Reduction Act of 1975. Each time a ceiling is imposed, the income tax structure becomes even more progressive. It is already highly progressive, and the savings of those in the higher tax brackets must help provide the capital needed for jobs and a higher standard of living for all citizens. (See page 10, item 2, of the statement, "Stabilization strategy must give greater weight to encouraging productive capital investment.").

Page 9 , *by* CHARLES KELLER, JR., *with which* FRAZAR B. WILDE *has asked to be associated*

I do not recognize that a case has been or can be made on a temporary tax reduction or rebate. It is my judgment that tax stability is essential to restore confidence and permit longer-range planning. If confidence is restored, increased economic activity will increase tax yields so that future revenue drains will be minimized or nullified. I would therefore oppose a temporary tax reduction or rebate.

Page 9 , *by* ROBERT R. NATHAN, *with which* FRAZAR B. WILDE *has asked to be associated*

Obviously, the easiest and perhaps quickest way to achieve fiscal stimulus is through tax reductions. However, there are two very difficult issues associated with principal reliance on this approach. One concerns the composition and nature of tax cuts and their longer-term implications. These issues are necessarily dealt with only briefly in this short statement. With respect to tax cuts, I would favor rebates rather than reductions plus some kind of direct income payment to those at the lowest levels of income who would not benefit from a tax rebate.

A far more important issue is the alternative of spending efforts compared with tax reductions. This CED statement leans far too heavily in favor of tax reductions and against increased public job-generating expenditures.

At a time when many cities and other governmental units in this country are in dire financial straits, due in considerable degree to restrictive federal fiscal and monetary policies, it would be a tragic mistake to focus principally on tax cuts and ignore the antirecovery steps that state and local governments are being forced to take. Schools are being closed because of lack of funds; police and fire protective services have been reduced; rat control programs have been abandoned; recreational programs have been curtailed; essential maintenance programs have been abandoned or cut back; slum clearance needs have been totally neglected; mass transit facilities are proceeding at a snail's pace; bond ratings are reduced, and this brings higher debt-service costs; regressive property tax rates are increased, with resulting heavy impacts on low-income groups; and endless other impacts. In 1976, the gap in state and local revenues will likely total $30 billion relative to full-employment revenues at existing tax rates. We need a substantial level of countercyclical revenue sharing.

There are desperate needs all over this country that should be given priority in terms both of stimulating economic recovery and of meeting critical needs. Tax reductions will mean a few extra dollars in the pockets of middle- and higher-income recipients. Recovery stimulation flowing from these extra dollars will not be as effective or warranted as expenditures for critically needed public services and facilities.

Many repeat the old litany that public works expenditures extend endlessly into the future and should not be relied upon for recovery purposes. We need not include in expenditure programs for recovery purposes outlays for major bridges and highways and huge building facilities. There are many needs that can be fulfilled in reasonably short time with efficiency and with maximum benefits. We probably need a new Harry Hopkins with the vision and nerve to support public needs via useful work. Maybe we cannot achieve 100 percent efficiency, but let us settle for 90 percent or even 80 percent efficiency and give priority to basic essentials.

Unemployment of untenable proportions is likely to continue for some time. Therefore, we ought to favor some risks of lags and inefficiencies on the expenditure side to use the stimulative fiscal measures for varied purposes. I favor splitting the needed sizable fiscal stimulation into at least half in the form of expenditures and not more than half in selective tax reductions.

Page 9 , by CHARLES KELLER, JR., *with which* FRAZAR B. WILDE *has asked to be associated*

I agree that programs are available and can be devised "that represent productive investments in the country's material and human resources." However, I believe that the "improvement of deteriorated railway roadbeds" is a most unfortunate example. The complex of problems involved in initiating such a program seem to me to guarantee delay in its implementation. Are funds to be made available through loans or grants only to financially troubled systems or to all systems based on traffic demands? Are systems that maintain their roadbeds to be penalized in favor of those who do not? Is area unemployment to be a factor in deciding which systems are to be approved, and on and on? I would prefer grants to states, urban areas, and federal agencies to implement public works projects for which plans are completed but not implemented because of lack of funds. I would also suggest grants to urban areas for low-interest loans to encourage housing improvements and restorations and perhaps grants for antipollution activities, all of which can be initiated promptly and phased out when the stimulus is no longer required.

Page 9 , by RALPH LAZARUS

In addition to the recommendations made in sections 1 and 2 under this heading, I believe that if we are to have satisfactory longer-term economic performance, it will also be necessary to:

Direct attention to the need for comprehensive tax reform for consumers and business. Such action should protect equity, promote increased saving, encourage new productive investment, and eliminate existing structural barriers to sustained improvement in the well-being of the nation.

Direct attention to the need to make substantial progress toward "full employment" over the next five years. Such progress will require growth in "real" economic activity averaging 5 to 6 percent annually in the 1976-1981 period. This superior economic performance will not only necessitate additional equitable tax relief for both consumers and business to support sustained expansion of demand and investment but also dictate continuing reduction of federal budget deficits to contain inflationary pressures. Within this context, implementation of new major federal spending programs will have to be constrained. In addition, comprehensive, continuing review of the purposes and effectiveness of all existing programs will be vital.

Page 11, by ROGER B. SMITH

I subscribe fully to this "guiding principle." The present policy statement could be viewed by many readers as endorsing a contrary principle.

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Representative BOLLING. Thank you very much, Mr. Lindsay.

Before I move on to the next witness, I would like to return the compliment to CED's study and recommendations. I think it was among the first of any group to diagnose correctly the dire situation that we were in This is really sort of standard for the CED. I have been on the committee long enough to know that the CED has played a major role, actually all the way back to the Employment Act of 1946, in creating that act and creating this committee an bringing to the dialog what we should do about the economy.

I want you to know I am very conscious of that and hope and expect we can count on the support of the CED in the future as we consider the problems today that are not new but are a collection of mature problems, because the economy of 1946 and the economy of 1977 are utterly different creatures. We are going to need a lot of help in following the responsibility of the Joint Economic Committee to try to take a look at the reality and make some suggestions as to what the future might hold and how it might be better lived. We will count on the CED to help us.

Mr. LINDSAY. I am grateful for your kind words and can give you assurance of all possible support.

Representative BOLLING. Thank you.

Mr. Kuhns.

STATEMENT OF DOUGLAS KUHNS, ASSISTANT RESEARCH DIRECTOR, INTERNATIONAL ASSOCIATION OF MACHINISTS & AEROSPACE WORKERS

Mr. KUHNS. Mr. Chairman and members of the committee, my name is Douglas Kuhns and I am Assistant Research Director for the International Association of Machinists and Aerospace Workers. I am appearing on behalf of Floyd E. Smith, International President of the Machinists Union.

The International Association of Machinists represents in excess of 900,000 workers in the aerospace, machine tool, air transport, railroad machinery manufacturing, metal fabrication and container industries and in hundreds of machine shops across the country. In such a broad cross-section of American industry, our people are well aware that added effort is required before there will be economic recovery for them and many others.

We appreciate very much the invitation to appear and to offer testimony on this very important legislation implementing the President's proposed economic recovery program. First of all, let me say that we are very pleased that there is a program. It is recognition of the fact that some economic recovery is sorely needed, and there has been some doubt in the recent past that this need was recognized.

While the commitment to a program, however, is an essential first step, once it is made, attention immediately turns to the composition of the program. We recognize, of course, that there are many pieces to such a program, and that every piece will have associated with it groups whose interest will be associated with those pieces. Nevertheless, it would appear that the major components of such a reconstruction program should be dictated by the character of the conditions to which the program is addressed.

The character of the economy's partial recovery since the low point in 1974, we feel, is quite instructive and is somewhat indicative of the kinds of responses that are required.

The initial recovery period from the first part of 1975, reinforced by the tax cuts enacted in 1975, encouraged many in the belief that rapid recovery was on the way. But much of this initial expansion was in the nature of business inventory recovery after a prolonged period of inventory decumulation. Although the gross national product rose by 7.3 percent over the year and unemployment declined from 9 percent to 7.3 percent, the failure of durable goods production to keep pace with this expansion during that time was a reflection of long-range caution over new investment.

Strong recovery of durable goods production in the course of previous recoveries has been a central feature in most postwar business cycles.

While the failure of fixed investment and durable goods growth to participate fully in the recovery was not especially retarding initially, it made itself felt during the following year when the rate of growth fell steadily again. The rate of unemployment increased again, and, this time numbers of our members began to join the ranks of unemployed.

More recently, the tide appears to have turned again, but the rate of growth promised appears to be hardly enough to sustain the annual increase in the labor force, and the rate of unemployment is likely to hang closely to its present levels.

Forecasts of economic activity for 1977 in the absence of governmental stimulus suggest a rate of growth in gross national product the range of 4 to 5 percent. This would not be sufficient to significantly affect the current level of unemployment. While consumer spending has been the principal support during the recent recovery, it has not been sufficient to provide a self sustaining economic expansion. By this point in previous postwar recoveries, real consumer income had advanced well beyond the high point of previous cycles. At the present, consumer incomes are only 4.4 percent above the prior peak; the whole gross national product is only 3.1 percent beyond the 1973 peak. Meanwhile, real fixed business investment is almost 12 percent below the previous high at the beginning of 1974.

In the wake of these developments, we would agree with the administration proposals that a two-pronged approach to solutions is required. There is the most immediate problem of getting people back to work. There is a longer-range problem of sustaining the future growth levels necessary to keep these people at work and to assure employment for the future increases in the labor force.

The administration's proposals for the immediate period ahead presumably are designed to get the economy off the mark. These are the proposals for an immediate tax rebate of $11.4 billion, a further $4 billion in tax reductions through liberalizing standard deductions and an additional investment tax credit or offset for payroll taxes of $2.5 billion for businesses.

The rationale for this proposal is quite understandable. Immediately reduced taxes will mean immediately increased consumer disposable incomes and, then, presumably, increased consumer expenditures for goods and services; consequently increased business sales and creation of expectations of a sustained rise in economic activity, according to one of the administration's spokesmen. And, it is further expected, that will elicit a response in the form of increased business willingness to invest in plant and equipment.

This is fairly conventional economic thinking; there will be an immediate increase in disposable consumer incomes and the total amount involved seems impressive. Under the pressure of skyrocketing fuel bills, increasing utility rates and other mounting costs related to energy shortages, it is very difficult to argue against immediate tax rebates.

Administrative spokesmen say an important immediaet objective is that a stimulus should take effect quickly. Therefore a one-time $11.4 billion rebate is to be paid out in April or May. Some rebates this spring might be desirable in terms of wiping out some of the impact of a very hard winter on many of our citizens. But, beyond this, we are unable to see how such conventional thinking can be translated into such short-term results.

Generally, it requires a protracted change in consumer income to produce very observable changes in consumer expenditure patterns. In their own, highly learned language, economists say the short-term propensity to consume is flatter, or more elastic, than is the case of the relationship between income and consumption over a longer period of time. This is simply to say that a given increase in income will not produce as much of a change in consumption as would be the case after the increase in income has become stable and the consumer has concluded that he can permanently change his life style for the better.

So, beyond the ameliorating immediate effects of the tax rebates, it is doubtful that they or the more permanent reductions in tax rates should make their effects felt for some time. Meanwhile, consumers will pay up old bills, attempt to replenish some of their lost savings and otherwise try to restore the ravages of unemployment and a very severe winter.

Business concerns will have a similar disposition, count their blessings in some increased sales, accept any new investment tax credits or offsets and wait, optimistically for more.

All of this is not to say that these various inducements will not result in some expansion of sales and general business activity. But, the root of our present stagnation has been very properly fastened on by the administration as a lack of increase in fixed business investment.

Induced investment is not built upon pipe dreams; it depends upon permanent, substantial improvement in expectations about the returns on risk capital into the extended future.

This is one of he most difficult aspects of dealing with our economic system as an ongoing system—so much of its operation is dependent upon inducements. Consumers should be induced to spend more income through tax rebates; but, they don't have to. Businesses should be induced to undertake more investment when their sales increase; but, they don't have to. Decreases in taxes to industry—in whatever shape or form—should induce them to invest more and expand; but, they don't have to. The current levels of industrial profits should induce industry to expand; but, it doesn't have to. The banking industry should be able to undertake some considerable loans on the basis of improved industrial potential; but it doesn't have to.

But, this is the way the economy is organized, and until we are ready to grapple with that particular problem, we have to recognize that short-term changes do not produce through inducement unless, somehow, they produce a long-term change in economic outlook.

From the current levels of profits in many industries, it is clear that slight increases from tax reductions are not going to produce additional inducements for investment or expansion. As far as consumers are concerned, hard pressed though many of them may be, they do not need the $11 billion in tax reductions anywhere near as much as that $11 billion is needed by those 7 million people who are unemployed. They, if they get the money, will spend all of it.

What is most drastically needed in the present economy are jobs. We would feel, then, that the large bulk of the recovery package should be put into jobs.

It is true that a jobs program requires more administrative effort and planning than tax adjustments. It also is true that a jobs program, ideally, should be directed to priority, targeted areas. Certain needs of the economy, for example, are not being addressed by the private sectors of the economy involved either because they are not disposed to do so, or they feel economic limitations of one sort or another are inhibiting.

In the meantime, the short-term need is great and the only way such a massive provision of jobs can be handled is through public investment and employment until such time as more permanent, long-term private employment can be induced from the economy. Public employment will provide additional incomes, additional consumer expenditures and sufficient promise of expanded sales as to induce businesses to undertake the self sustaining growth and employment that is needed.

Fortnuately, some of the priority areas for employment have already been identified, and should not require extraordinary advance planning. We have tremendous needs for public construction, much of which cannot be handled through local financing at today's high cost. Private business points to this as an additional exacerbation of what they call the capital shortage, which inhibits their willingness to expand investment. Federal expenditures in the area of public works will free up income for investment in the private sector which can then respond to additional expenditures and to a greater availability of capital as well.

Moreover, many local authorities, faced with mounting financial pressures and reduced tax revenues, much of it related to unemployment, have had to reduce their public employments and have greater and greater difficulty in providing needed public services.

Finally, the shortage of housing construction in this country has been documented so much and so many times that it hardly needs mention again.

Again, fortunately, these priority, targeted areas already are on the legislative books and tremendous lead time is not needed for planning and administrative organization.

It is for these reasons that we subscribe to the revision in the administration's economic program put forward by the AFL–CIO and so eloquently laid out by my colleague, Andrew Biemiller of the AFL–CIO before the House Budget Committee on January 25.

The first point in this program is an extended program of public works. The current authorization of funds for title I of the Local Public Works and Capital Development and Investment Act of 1976 should be drastically expanded. Based up on the response that was secured in applications for funds for project proposals within 45 days of the passage of the appropriation, it is clear that the AFL-CIO's proposal for an additional $10 billion could be translated into jobs almost immediately.

While it is true that a large proportion of the jobs generated would be in construction, this is an area that has been particularly hard hit by unemployment. But, the incomes engendered by this employment would go a long way towards the spending stimulus businesses say they need to generate jobs in the private sector.

The same can be said for the AFL-CIO proposal for increased public service employment of an additional 800,000 jobs, representing $8 billion. Under Title VI of CETA, $2.8 billion is currently appropriated and some 260,000 workers are employed. The AFL-CIO feels this program could provide a million jobs. While these jobs could not be filled immediately, AFL-CIO estimates suggest that they could be filled at the rate of about 60,000 a month. We cannot imagine that the effect of tax rebates upon the operation of the economy could be as quick in moving us along toward recovery.

The labor program also recommends an additional $2 billion be appropriated for countercyclical fiscal assistance to State and local governments over the next fiscal year to help their agencies maintain basic services and avert the additional layoffs that threaten to further aggravate unemployment problems.

An additional $2 billion is recommended in added budget authority for youth employment and training. A number of programs are involved and they should be expanded to alleviate the special unemployment problems of young people. A number of them are training oriented and should be increased substantially.

The existing housing programs should be expanded to alleviate the housing shortage. The AFL-CIO proposal recommends an $8 billion expansion. Tandem plan below market interest rate financing should be continued to maintain a high level of single family home construction, and should be extended for multifamily subsidized and nonsubsidized rental housing. A total of $5 billion for tandem plan funds already is authorized but was not appropriated.

In short, the AFL-CIO proposal advocates an expenditure of $30 billion over the next year to get this country on its feet by producing about 2 million jobs.

One of the compelling arguments for this program lies in the apparent fact that, not only do specific job creation programs produce the most jobs for each dollar spent as compared with tax cuts, but any given number of jobs produced in this manner costs less. The net cost of a job to an otherwise unemployed worker is reduced as he ceases to draw social welfare payments and returns taxes to the Federal Treasury.

According to Congressional Budget Office figures, it would require a $20 billion tax reduction to induce the creation of about 600,000 jobs, at a net cost to the Treasury of more than $16.5 billion. The same number of jobs can be created through a public works program with only half as much in direct Federal expenditures, at an ultimate net cost of about $5 billion.

Tax cuts cannot be targeted to areas of high unemployment any more than to areas that are less in need, nor to individuals whose needs are the greatest. There are lags in individual spending produced through tax cuts, which will delay the production of jobs and reemployment of our idle productive capacity. We therefore would urge that the bulk of the recovery program should be pointed to the direct funding of the works programs that will have the quickest impact on unemployment and the economy's general recovery.

Representative BOLLING. Thank you, Mr. Khuns.

Mr. Seibert.

STATEMENT OF DONALD V. SEIBERT, CHAIRMAN OF THE BOARD, J. C. PENNEY CO., INC.

Mr. SEIBERT. Good morning, Mr. Chairman and other distinguished members. I am Donald V. Seibert, chairman of the board and chief executive officer of the J. C. Penney Co. It is a pleasure to be here today. It is my intention to confine my remarks to areas where we as merchandise retailers might have some special insights.

J. C. Penney is part of the general merchandise retailing industry, whose major activity is the sale of general merchandise, accessories, and furniture and household furnishings. In 1976, sales in this industry were $160 billion or approximately 25 percent of total retail sales. J. C. Penney's sales in 1976 were $8.33 billion.

Because our business has weekly sales peaks and peak selling seasons during the year, we employ a large number of part-time associates. Approximately 40 percent of all of our associates in our stores are part-timers.

In 1976, we hired about 150,000 new associates, most of whom were essentially unskilled and a large number of whom were entering the labor force for the first time.

During the course of a year, approximately 60 percent of all adult shoppers in the United States enter a J. C. Penney store at least once. Consumer attitudes have changed significantly since the 1960's. Currently we see ourselves facing a consumer who is more cautious and more interested in building savings than the consumer we faced during the 1960's. We feel that consumers with these attitudes can help extend the economic recovery.

We expect 1977 to be a good year for consumers. We do not expect them to go on a spending spree. We expect the growth in consumer income will support sales growth of 11 percent in 1977. In 1976, household durable sales grew at a faster pace than apparel sales.

We expect this trend to continue in 1977. Demand for household durable merchandise is barely back to its pre-recession level after adjusting for price increases. A strengthening housing market will stimulate demand for this merchandise as well as for soft household furnishings.

Demand for apparel should be fairly strong in 1977, possibly up as much as 10 percent over 1976. We expect prices in the general retailing industry to rise about 5 percent in 1977. This compares with 5.4 percent increase we expect for all consumer prices. Price increases in our industry have traditionally been below the level of general price increases in our economy.

Despite our general optimism on economic outlook in 1977, we feel that the confidence of consumers and businessmen will be benefited by a stimulation package. We are concerned about the possible inflationary effect of too much stimulation. The question of whether or not a tax rebate is the best approach to building consumer confidence and promoting increased economic activity is of considerable interest these days. In our prepared statement, we discuss the impact of the 1975 Tax Reduction Act on our industry and our company. Our sales were affected immediately and substantially. We can discuss the figures if you wish. Any long-term impact of the 1975 tax measures was not apparent.

The current situation is very different from that which we faced in the spring of 1975. While consumers remain cautious, they are certainly in a better frame of mind than they were then. Today consumer optimism is building, not at a rapid pace, but building nonetheless.

We feel that it is unlikely that a large percentage of any rebate would be saved by consumers or used to reduce indebtedness. We would expect retailers like ourselves to benefit from increased sales volume. Neither the general economy nor consumers currently are in the fairly desperate situation of early 1975.

At that time, a rebate gave the economy a quick shot in the arm and provided consumers with additional purchasing power rapidly. At this point, we feel a permanent tax reduction for individuals would be preferable to a rebate. In our opinion, this tax reduction should be enacted in such a way that law- and middle-income individuals are the largest benefactors.

It is our belief that the confidence of consumers will be bolstered more by a permanent tax reduction that can be counted on than from a one-time rebate and that this will ultimately result in more stimulus to consumer spending activity. A permanent tax reduction will allow consumers to better plan their future purchases.

With respect to the severe problem of youth unemployment, we feel that training can be a part of this. We feel that we can help in training some numbers of these young people for jobs that exist in our company.

The number of jobs involved is comparatively small against the size of the overall problem. However, we feel that long term, this problem may be significantly relieved by many such small steps. Training is only a part of the solution to this problem. Unless the economic climate is suitable for the creation of additional jobs, we would simply be training people to take jobs which would have otherwise gone to someone else.

We need an economic climate where substantial numbers of new jobs are being created to really make inroads in reducting the unemployment problem or for that matter, reducing the general high level of unemployment.

We favor the proposal to allow business to choose either an increase in the investment tax credit or a tax credit equal to 4 percent of the social security payroll tax.

The social security payroll tax credit will be the one chosen by many labor-intensive companies like those in our industry.

Since J. C. Penney is a large capital investor, the impact of the two options on our tax payments is close, but the social security payroll tax option is probably slightly preferable for us.

This tax benefit will have the effect of increasing our internally generated cash and reducing our borrowing needs. We do not, however, see it having any immediate impact on jobs.

Over the next several years, the additional cash generated will have a modest impact on employment as it will increase our available capital and ultimately our investment activity. There have been a number of proposals involving the business sector that would over the long term have a major impact on jobs.

In one form or another, these involve providing business with adequate capital and investment incentives to make the expenditures necessary to provide a significant number of new jobs in our economy.

I won't go over the various proposals as others have adequately covered them. Rather, I would like to cover a related area which we feel received inadequate attention, and that is productivity.

Since 1950, as much as 70 percent of the economic growth in this country was due to increased productivity. Increased productivity is the only way real wages can grow; and it is a basic element in an improved standard of living.

Productivity gains in the retail sector are not easy to come by. This is particularly worrisome for us since prices in our industry have not risen as fast as our costs of doing business. Increased productivity is therefore a must unless we want to see our profit margin shrink and ultimately disappear.

Several years back, we put together a high-level management team to study the problem of productivity in our company. We found opportunities to utilize our store space more effectively. We found that organizational changes aimed at a close liaison between our selling, buying, and marketing staffs improved productivity. We found that providing key decisionmakers with better information improved productivity as did better planning.

Many opportunities remain. We feel encouraged by the progress we have already made. Our plans for the next few years are based on a feeling of confidence that we know how to employ our resources more productively. Our plans call for a fairly sizable increase in the number of jobs that will be created at J. C. Penney in the next 5 years and beyond.

We feel that the problem of increasing productivity needs to have greater encouragement by government, with the Federal Government taking a leadership role. As part of this effort, private research and development activities aimed at improving productivity could be encouraged through tax incentives.

The Government might choose to directly fund research and development projects that have as a goal improving the productivity in broad segments of our economy.

All laws, regulations, restrictions, and operating procedures should be carefully scrutinized to evaluate their impact on productivity in this country. Where impediments to productivity are uncovered, efforts must be made to remove or alleviate them. Even when legal restrictions or procedures are thought necessary for the benefit of some segments of our society, additional thought must be given to the effect on the common objective of improving productivity.

Improving productivity does not imply that workers need to work harder. Improving productivity means that the system needs to be made more efficient. Output per man-hour has increased several times over in the past 50 years; and I do not think that many of us feel that we work several times as hard as our grandparents. However, I should add that I am not opposed to hard work.

When productivity is rising, companies have a real incentive to expand and create new job opportunities. When productivity is rising, employees can see the fruits of their labor in rising real income and purchasing power. Improving productivity is also the best way I know of to keep inflation in check. When productivity is increasing, both workers and investors are being amply rewarded. This alleviates the pressure to seek inflationary wage increases and to seek inflationary price increases.

We simply feel that a better recognition of the positive impact of productivity on all of us and a removal of obstacles to productivity would go a long way to improving employment opportunities in this country and lowering the threat of a renewed inflationary spiral.

As we indicated at the beginning of this statement, we have confined our remarks to areas where we feel our experience provides us with some special insights. We hope that what we have had to say is helpful.

Consumers play a very important role in our economy. We believe we have a good vantage point from which to assess the changing attitudes and purchasing activity of consumers. Whenever our views can be useful, we will be glad to make them known.

The retailing industry is important to our economy. Today one out of every six members of the work force is employed in the retailing sector of our economy. I believe it is important that representatives of this sector of our economy contribute more frequently in forums such as this one.

[The prepared statement of Mr. Seibert follows:]

Prepared Statement of Donald V. Seibert

Introductory Remarks

It is my belief that we can be of greatest assistance to the Joint Economic Committee by commenting on those areas where we as general merchandise retailers might have some special insight. Consequently, this prepared statement will cover our views on the current mood of consumers, the consumer outlook in 1977, and the ways in which we see certain types of policy alternatives impacting on consumers and on our industry.

We greatly appreciate the opportunity to present our views on these important subjects. I will begin briefly describing the industry in which JCPenney competes.

General Merchandise Retailing

In 1976, retail sales in this country amounted to nearly $650 billion. Approximately 60 percent of all the money consumers spend is spent in retail establishments.

The retail industry includes several large sectors, such as food and automobile retailing, in which JCPenney has either limited involvement or no direct involvement at all. Our segment of the retail industry is commonly referred to as general merchandise retailing.

Included in this industry are all establishments whose major activity is the sale of general merchandise; apparel and accessories; or furniture, home furnishings, and household equipment. The industry comprises the types of retail outlets operated by the national general merchandise chains—Sears Roebuck, JCPenney, and Montgomery Ward; traditional department stores such as J. L. Hudson,

R. H. Macy, and Woodward and Lothrop; discount stores such as Kresge's K-Mart and Zayre; catalog firms such as Spiegel and Alden; variety stores such as Woolworth; specialty stores selling everything from women's apparel to electronics; and thousands of small general merchandise stores around the country. In 1976, sales of the general merchandise retailing industry were about $160 billion or 25 percent of all retail sales.

The general merchandise retailing industry is very competitive. The 1972 Census of Retail Trade reported over 300,000 individual general merchandise retail establishment in the United States. Almost 90 percent of these establishments were quite small, with annual sales ranging from less than $50,000 to $500,000.

JCPenney is a major factor in this industry, operating more than 2,000 retail establishments in the United States and Europe. The Company traces its roots back to 1902 when James Cash Penney opened a small soft goods store in Kemmerer, Wyoming, which he named the Golden Rule Store.

During the 1960's, JCPenney greatly enlarged and diversified the scope of its operations. At the beginning of the decade, the Company was essentially a national chain of relatively small soft goods and apparel stores. By the end of the decade, JCPenney had been transformed into a major U.S. retailer, operating large department stores offering a full range of merchandise in major metropolitan areas across the United States.

Along the way we also entered the catalog business, where we are currently No. 3 nationally; the drugstore business by acquiring Thrift Drug Company; the food retailing business through Supermarkets Interstate; and the discount store business by starting our Treasury Stores Division. We also began operating stores in Belgium and Italy and entered the financial services field where we currently sell accident and health, life, and casualty insurance. JCPenney stores, however, remain by far our major sales and profit generator.

Company sales for fiscal 1976, which ended last month, were $8.35 billion. At the end of the year, a seasonally low employment period for us, we had approximately 184,000 associates on our payroll. JCPenney, like many companies in our industry, makes extensive use of part-time help to cover peak selling times during the week and to cover peak selling periods during the year. This provides an opportunity for many housewives, students, and others who can't or don't want to work full time to select a work schedule which suits their requirements and ours. About 40 percent of all store associates are part-timers. Last month, we mailed out 368,000 W-2 forms to associates in this country who worked for us at some time during calendar year 1976. (Our employees have always been called associates in order to reinforce Mr. Penney's original concept of working together rather than working for someone.)

In 1976, we hired about 150,000 new associates, most of whom were essentially unskilled and a large number of whom were entering the labor force for the first time. Each year we are one of the largest employers of essentially unskilled associates in the country. We also employ a large percentage of women and teenagers. About 70 percent of all our associates in this country are women. Our employment of teenagers varies throughout the year but is typically well above 10 percent and ranges up to 15 percent of our total workforce in this country—teenagers account for about 10 percent of the total U.S. Labor force.

Our industry is generally considered labor intensive, yet many of the larger retailers like JCPenney are major investors of capital. We do not have final figures for fiscal 1976 yet, but we estimate capital expenditures were about a quarter of a billion dollars. These expenditures were largely for new stores and support facilities, fixtures, store modernizations, and new equipment.

THE MOOD OF THE CONSUMER

Our vantage point provides us with a fairly good view of the U.S. consumer. About 60 percent of all the adult shoppers in the United States entered a JCPenney store at least once last year.

Let's begin discussing the consumer by reviewing a little history. During the 1960's, consumers experienced a significant upward movement in their purchasing power. From 1959 to 1969, median family income in this country rose by 38 percent in real or constant dollars. People were beginning to take a steadily improving standard of living almost for granted.

The 1970's, which were looked forward to with great expectations, have proven to be a very sobering period for consumers. In real terms, median family income did not rise at all from 1969 to 1975. Consumers have already been through two recessions in the 1970's and have learned that double-digit inflation and an unemployment rate of 9 percent are possible within our economy.

In many ways, 1976 was a year of solid recovery for the U.S. economy and the consumer. Total gross national product rose by 11.6 percent with 6.2 percent representing real growth—the biggest increase in real GNP in 21 years. The disposable income of consumers rose by 9.3 percent, and their spending was up by 10.8 percent. It was a year in which considerable progress was made in reducing inflationary pressures. At the end of the year, three million more Americans were at work than at the end of the previous year.

After a strong first quarter in 1976 consumer spending did become sluggish in the second and third quarters. This adversely affected our sales of both soft and hard lines merchandise in those two quarters. We weren't missing our sales budget by a great deal each month, but as the pause persisted, we grew a little concerned about unplanned inventory accumulation, particularly in the apparel area.

Starting in October consumer spending picked up, and it has remained fairly strong until the recent cold weather conditions. Total retail sales were up at a seasonally adjusted, annual rate of 12.7 percent in the last three month of 1976 from the prior three-month period. General merchandise retail sales were up at an annual rate of 15.6 percent during this period. The tempo of our own Company sales performance strengthened in October as well and remained reasonably strong until the latter part of January.

Our sales in January were up 9.4 percent from last January, but this was not as strong a performance as we had anticipated. The weather definitely had an adverse impact on sales in the latter part of January, particularly in those regions of the country hardest hit by storm and cold weather. We expect our February results to be adversely affected by the storms and cold weather that occurred after January 29, which was the last day included in the reported results for January. Whether or not our business suffers serious effects largely depends on weather conditions during the remainder of the winter. The large increase in home heating bills experienced by many consumers will undoubtedly cause a reallocation of consumer income that otherwise would have gone into retail sales.

Some areas of our business have been favorably affected by the cold weather. Catalog sales have generally been strong as many consumers choose to order needed merchandise by mail or by phone rather than going to a store in cold and sometimes hazardous weather. Remaining stocks of winter-weight apparel have been depleted. Sales of our low maintenance, heavy duty automobile battery have been exceptionally strong, and oher automotive merchandise is selling briskly as well.

Aside from the impact of the weather, we are encouraged by the trend of consumer spending in recent months. We feel that consumers are becoming more confident and that 1977 can be a year in which consumer confidence will continue to grow.

Nevertheless, we believe that consumers today differs materially from those of the 1960's. The events of the 1970's have produced a more cautious, more value conscious consumer than was in evidence in the 1960's. We expect to be facing such a consumer at least over the remainder of this decade.

The impact of the economic problems of the 1970's on consumer attitudes is not all bad, in our opinion. Consumers are adding to their savings and not letting themselves become overburdened with debt. In the 1974-75 recession, our credit customers began paying off a larger proportion of their monthly balances, reflecting a lack of confidence and a desire to become more liquid. Despite the general improvement in the economic climate in 1976, consumers continued to pay off their balances at a higher than expected rate, indicating a continued caution regarding indebtedness.

It is our belief that a consumer acting in this way and avoiding excesses will help to extend the recovery period and moderate any further economic downturns if they do occur.

The experience of the 1970's has made a deep impression on businessmen as well as consumers. We too have learned the price of excesses. Most businessmen I know are paying close attention to the productivity of their investments and being extremely careful not to build excess inventories. This cautious attitude among businessmen, unless carried to an extreme, will also serve to prolong the recovery in our opinion.

We look on the 1970's as a period when we all have learned a few things. We have learned that inflation and unemployment do not have fairly predictable upper limits. We have learned that our resources are limited and must be conserved. We have learned that we don't have pat solutions to all the economic problems we encounter. If these lessons are properly applied, the 1970's to date may have been worth the price.

CONSUMER OUTLOOK IN 1977

We view 1977 as a year in which economic expansion will continue although at a slightly slower pace than in 1976. We anticipate real growth of just under 5½% in 1977. Adding higher prices we see total GNP up about 11% in 1977. The second half of 1977 might be slightly stronger than the first half, if business spending picks up in the latter part of the year.

The most distributing economic problem is unemployment. The 7.3 percent unemployment rate in January is considered by most an aberration, and a higher rate is expected in the months ahead. Among teenagers, unemployment is close to 20 percent and for minority teenagers nearly 40 percent. Plant closings and lay-offs due to the cold weather conditions will likely contribute to the unemployment problem in February and possibly beyond.

The unemployment rate will come down over the course of 1977 and should be below 7 percent by the end of the year. In our opinion, President Carter's announced goal of 6½ percent by yearend will be quite difficult to achieve.

Inflation will remain a concern in 1977, but price increases should decline slightly from the 1976 rate. As measured by the Consumer Price Index, we see inflation easing to 5.4 percent in 1977 from the 5.8 percent pace of last year.

While we expect 1977 to be a good year for consumers, we do not expect them to go on a spending spree. We believe that consumers will continue to save at a fairly high rate—about 7 percent of their disposable income in 1977. As we said earlier, we consider the consumer's attitude to be generally cautious and value conscious. Nevertheless, the growth in consumer income should support an increase in consumer spending equal to the 11 percent growth in overall economic activity we expect.

On the assumption that cold weather conditions will be short-lived, we expect sales in the general merchandise retail industry to grow by about 11 percent in 1977 and thereby to keep pace with the growth anticipated for total consumer spending. Some of the factors which inhibited sales growth in our industry in 1976 (a sharp increase in consumer spending on automobiles and rapid growth in the cost of essential consumer services) are unlikely to be as important in 1977.

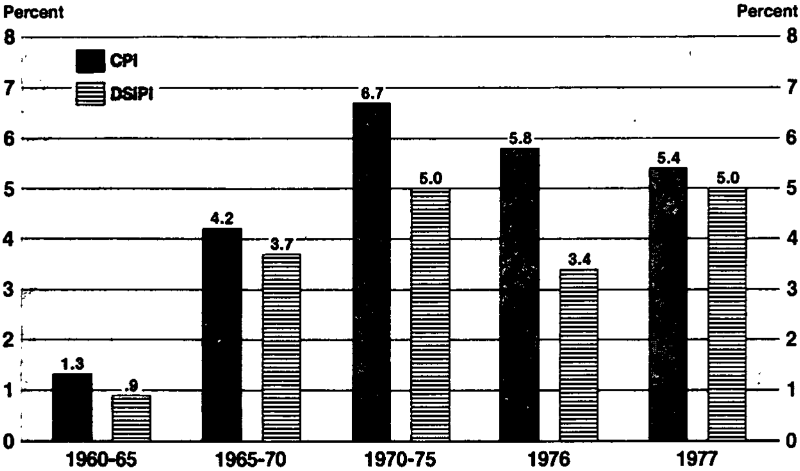
In 1976, household durable sales grew at a faster pace than apparel sales. We expect this trend to continue in 1977. Demand for household durable merchandise is barely back to its pre-recession level, after adjusting for price increases. The strength in housing activity expected in 1977 will stimulate demand for this merchandise as well as for soft household furnishings. Demand for apparel should be fairly strong in 1977, possibly up as much as 10 percent over 1976.

We expect prices in the general merchandise retailing industry to rise by about 5 percent in 1977. This will largely reflect the increased cost of goods from suppliers. This compares with the 5.4 percent increase we expect for all consumer prices. Price increases in our industry are typically below the general level of price increases.

The chart below compares price trends in our industry as measured by Department Store Inventory Price Index of the Bureau of Labor Statistics with those for the overall Consumer Price Index. The Department Store Inventory Price Index is only available in January and July, and the percentage changes are based on July to July comparisons. The CPI changes are based on annual averages for the whole year.

Consumer Prices vs. Department Store Prices

Average Annual Percent Change



In summary, we view as favorable the prospects for consumer income growth in 1977. Inflation remains too high, but consumers have learned to scope with inflation rates that are not too excessive or too volatile. We see price increases generally ranging between 5 and 6% in 1977. In our opinion, the real purchasing power of the total consumer sector should grow by about 5% in 1977.

We are, therefore, generally optimistic about the outlook for consumers in 1977. They should end the year in better shape than they began it. We recognize that unemployment will still be too high at yearend but feel that significant progress will be made in reducing unemployment over the course of the year.

IMPACT OF PROPOSED STIMULATION POLICY ALTERNATIVES

Despite our generally optimistic view of the economic outlook in 1977, we feel that the confidence of consumers and businessmen would be beneficially influenced by a stimulation package. We do share the concern of those who are fearful of the inflationary impact of the stimulation package that is ultimately adopted. The situation is quite different from what it was in early 1975. Consumer spending was fairly strong prior to the recent spell of cold weather, and we feel this strength will resume when the cold weather is behind us. We don't know how to put an exact figure on the amount of stimulation that is optimal, but the President's two-year package of $31 billion sounds about right to us.

CONSUMER STIMULUS

The question of whether or not a tax rebate is the best approach to building consumer confidence and promoting increased economic activity is of considerable interest these days. Before discussing our position on this question, we thought you would be interested in an analysis we did of the impact of the tax rebate program in 1975.

As a result of the Tax Reduction Act of 1975, consumers received rebate checks in May and June, lower withholding rates for individuals went into effect in May, and a special one-time $50 payment to social security recipients was sent out at the end of June. These measures increased disposable personal income by about $11.5 billion in the second quarter of 1975. The is quite close to the magnitude of the tax rebates and social security payments proposed by President Carter.

The $11.5 billion amounted to just over 4% of the disposable personal income received by consumers in the second quarter of 1975. Consequently, it is difficult to say precisely how consumers used the rebate checks in isolation from the way they made use of their other income. Nonetheless, some general observations can be made.

The sharp increase in the rate of consumer savings in the second quarter of 1975 to 9.6% from the 6.6% rate of the first quarter indicates that as much as two-thirds of the $11.5 billion intially went into savings. To a great extent, this was a result of timing. Savings represent a residual figure, i.e., all income recieved that is not spent is considered savings. Many checks were received late in the second quarter, and if these were not spent immediately, they were counted as savings.

The impact on spending in the second quarter was noticeable. Personal consumption expenditures were up at a seasonally adjusted annual rate of 9.7% in the first quarter. This rose to 11.6% in the second quarter. Since the rate of inflation was slowing at this time, the change in real terms was greater. Consumer spending adjusted for inflation went from an annual rate of increase of 3.5% in the first quarter to 6.8% in the second.

Sales in the retail industry provide another indication of the impact of the Tax Reduction Act of 1975. Total retail sales in the first quarter of 1975 increased at a seasonally adjusted annual rate of 5.0% from the last quarter of 1974. In the second quarter, retail sales rose at a seasonally adjusted annual rate of 18.4%. As indicated below, sales of general merchandise retailers also improved substantially.

CHANGE IN RETAIL ACTIVITY

[Seasonally adjusted annual rate of change, in percent]

	1975	
	1st quarter	2d quarter
Total retail sales	5.0	18.4
Sales of general merchandise retailers	7.4	16.6

Source: U.S. Department of Commerce.

The quarterly figures above are based on the fiscal quarters used by many general merchandise retailers—February, March, and April constitute the first quarter; May, June, and July the second quarter. This provides a convenience basis of comparison as the direct impact of the Tax Reduction Act of 1975 began in May.

Sales of JC Penney were affected immediately by the tax rebate program in 1975. Our store sales (including catalog desks in stores) were budgeted for a 3.5 percent gain in the first quarter of 1975 (February, March, April) from the first quarter of 1974. We actually had a 3.1 percent sales loss. We did not make our monthly sales budget in any month, and we ended the quarter with a 10.6 percent sales loss in April against a budgeted loss of 3.2 percent. In May, as the lower withholding rates went into effect and consumers started to receive the rebate checks, we had a 3.1 percent sales gain against a budgeted gain of 2.7 percent.

We went on to beat our budget in each month of the (May, June, July) second quarter. For the quarter, we had budgeted for a 3.0 percent sales gain. We achieved a 5.0 percent gain. The reversal in our sales trend was even more pronounced in real terms, since the rate of price increases was declining fairly sharply during this period. We talked to a large number of our store managers at that time to get a reading on the impact of the rebate on our business. The large number of rebate checks we were cashing right in our stores was very impressive.

Money going into savings can be used in many different ways. The additional savings of consumers in the second quarter of 1975 mainly went into checking accounts and pocket cash or to reduce indebtedness. Flows into savings accounts did not show any significant increase in the second or third quarter of 1975. There was some increase in securities investment in the third quarter, but not very much.

The money that went into demand deposits and pocket cash in the second quarter probably was used to support consumer spending in the third quarter. Consumer spending was not particularly strong in the third quarter—it only rose at a seasonally adjusted annual rate of 4.1 percent in real terms. The sharp rise in automobile sales in the third quarter of 1975 (an annual rate of increase of 55 percent) could indicate that some consumers held on to their rebate checks until they accumulated enough additional cash to apply toward the purchase of a new car.

Some of the rebate money did go to pay bills. It is extremely difficult to quantify the amount. At JC Penney we saw our average credit balance drop sharply in the spring of 1975 as our customers held down their purchases and used at least a part of their rebate checks to reduce their outstanding balances. When consumers pay off their debts, it increases their open-to-buy in future periods if they desire to take advantage of it.

The one fairly solid conclusion we feel we can make is that in the second quarter of 1975 consumer spending and, in particular, retail sales did benefit from the extra disposable income consumers received as a result of the Tax Reduction Act of 1975. We can further surmise that consumer spending in the third quarter was helped to some extent. This is more speculative, however, and the effect, if any, was certainly less than that observed in the second quarter.

The current situation is very different from that which we faced in the spring of 1975. While consumers remain cautious, they are certainly in a much better frame of mind than they were when they received the benefits of the 1975 Tax Reduction Act. The pace of real economic growth declined at a 9.9 percent annual rate in the first quarter of 1975. The unemployment rate stood at 7.9 percent at the beginning of the year and rose to 9.0 percent in May when the distribution of rebate checks began.

Today, consumers' optimism is building—not at a rapid pace, but building nonetheless. Consumers are quite liquid compared to the spring of 1975. We feel it is unlikely that a large percentage of any rebate would be saved or used to reduce indebtedness. We think it would be spent fairly quickly and that retailers like ourselves would benefit from the increased sales volume. This belief is based on the assumption that consumers will have already paid their higher home heating bills by the time any rebate checks are in their hands.

Neither the general economy nor consumers in general are currently in the fairly desperate situation of early 1975. At that time, a rebate was needed to give the economy a quick shot in the arm and to provide consumers with additional purchasing power as rapidly as possible.

Under the present circumstances, we feel a permanent tax reduction for individuals wouldl be preferable to a rebate. This tax reduction should be developed in such a way that low and middle income individuals are the largest benefactors. Without putting an exact dollar figure on the size of this tax reduction,we feel it should be about equal on an annual basis to the size of the proposed rebate it replaces in 1977.

It is our belief that the confidence of consumers will be bolstered more from a permanent tax reduction that they can count on than from a one-time rebate and that this will ultimately result in more stimulus to consumer spending activity than will a rebate. A permanent tax reduction will improve consumers' ability to plan their purchases.

JOBS

While the economy is generally much improved in the last year, it has not improved for the 7½ million Americans unemployed. We are well aware of the social and economic problems such a high level of unemployment creates.

It is very difficult to react to all the proposals to create jobs that have been made. We believe that training programs are a part of the solution for reducing unemployment among the young. If we can provide properly motivated young people with useful skills we should be able to reduce significantly the disportionately high unemployment rate of this segment of our work force.

We've thought about this problem at JC Penney. We feel we do have some jobs that could be filled by currently unskilled young people who want to develop useful skills. We feel we have the ability to train these people.

Specifically, we could train young people in some automotive skills to qualify them for jobs in our 400 automotive centers around the U.S. We could train young people for jobs in the appliance and electronics service areas of our business. We could train young people to work in our distribution facilities. We could train young people in basic clerical skills. There may be other areas as well.

We're not sure just how many jobs are involved here. A thousand or so perhaps. This is not a lot of jobs when one considers the magnitude of the problem—nor is training the only solution to the unemployment problem among young people. Nevertheless, we're not sure that any one massive program can be developed that is going to solve this problem. We feel that the problem may best be solved in thousands of small steps such as those we've just outlined.

Of course, providing young people with skills to qualify them for productive employment only makes sense if job opportunities are expanding. Otherwise, you're simply giving a job to someone you've trained rather than someone else. Likewise, the whole unemployment problem will not be alleviated unless we can find a way to increase the number of jobs available in our economy.

We generally support President Carter's proposal allowing business to elect either an increase in the investment tax credit from 10 percent to 12 percent or a tax credit equal to 4 percent of social security payroll tax payments. Business has suffered along with consumers from the effects of inflation and the 1974–75 recession. We're glad the administration recognizes that not all firms uniformly benefit from changes in the investment tax credit. The social security payroll tax option is the one that many companies in labor intensive industries such as ours will elect. The tax benefits for J. C. Penney are reasonably close for both options but we will probably benefit slightly more from the social security payroll tax option.

This tax benefit will have the effect of increasing our internally generated cash and reducing our borrowing needs. We do not see it having any immediate impact on jobs. Over the long run the additional cash generated will have some impact on employment as it will increase our available capital and ultimately our investment activity. Nevertheless, for our Company and probably for many others even the impact on job creation long term will be limited as the tax benefit and the related increase in capital funds available would be fairly small.

There have been a number of proposals involving the business sector that would over the long term have a major impact on jobs. In one form or another these involve providing business with adequate capital and investment incentives to make the expenditures necessary to provide a significant number of new jobs in our economy. We won't go over the various proposals as others have adequately covered them. Rather, we would like to cover an area which we feel receives inadequate attention, that is, productivity.

PRODUCTIVITY

There are only two ways to increase real output—through increased productivity or through increased labor input. Since 1950 productivity has accounted for something approaching 70 percent of all the real growth in our economy. While productivity improvement is dependent on all factors of production, it is often measured as the change in the amount of output per individual in a given period of time. Productivity improvement is the only way to improve real wages and is the basis for improvements in the standard of living.

A dramatic example of the effects of productivity can be seen in our agricultural sector. Today, less than 4 percent of our workforce is engaged in the agricultural sector versus 50 percent one hundred years ago. The productivity of this sector of our economy is a major factor in the relatively high standard of living we enjoy in this country. The reduction in the proportion of our workforce required to feed the country allowed for a large increase in the workforce available for other productive jobs in our economy.

In our opinion, increased productivity is essential if we are to provide all the new jobs that are required in our economy. Productivity encourages investment. It also helps contain inflation and provides consumers with real income gains.

We have learned a lot about productivity at JC Penney. As you're probably aware, productivity increases in retailing are not easy to come by. This is particularly worrisome to us since prices in the general merchandise retailing industry have not risen as fast as general price levels, and consequently, our costs tend to increase faster than our prices. Increased productivity is, therefore, a must unless we want our profit margins to shrink and ultimately disappear.

Several years back we put together a high level management team to study the problem of productivity in our Company. This effort and the increased interest in productivity improvement it developed throughout the Company uncovered many opportunities.

We found opportunities in stores to utilize our space more effectively. We found that organization changes aimed at a closer liaison between our selling, buying, and marketing staffs improved productivity. We found that providing key decisionmakers with better information improved productivity, as did better planning. We found better ways to train associates also improved productivity. The list is quite long.

Many opportunities remain, but we feel greatly encouraged by the progress we've already made. Our plans for the years ahead are based on a feeling of confidence that we know how to employ our resources productively. Our plans call for a fairly sizeable increase in the number of jobs that will be created at JC Penney in the next five years and beyond.

We feel that increasing productivity needs to be given greater encouragement by governmental bodies, with the federal government taking a leadership role. As part of this effort, private research and development activities aimed at improving productivity could be encouraged through tax incentives. The government might directly fund research and development projects that have as a goal improving the productivity of broad segments of our economy.

All laws, regulations, restrictions, and operating procedures should be carefully scrutinized to evaluate their impact on productivity in this country. Where impediments to productivity are uncovered, efforts must be made to remove them. Even when legal restrictions or procedures are thought to be necessary for the benefit of some segment of our society, this benefit must be weighed against the common objective of improving productivity.

Improving productivity does not imply workers need to work harder. Improving productivity means that the system needs to be made more efficient. Output per manhour has increased several times over in the past 50 years. I don't think many of us feel we currently work several times as hard as our grandparents.

When productivity is rising, companies have a real incentive to expand and create new job opportunities. When productivity is rising, employees can see the fruits of their labor in rising real income and purchasing power.

Inflationary pressures have subsided from the high levels of recent years. Nevertheless, inflation is a continuing concern to consumers, and it is to us. It is our belief that a renewal of high rates of inflation would be one of the surest ways to precipitate an economic downturn.

Improving productivity is one of the best ways to keep higher rates of inflation in check. When productivity is increasing, both workers and investors can be amply rewarded. This alleviates the pressures for working people to seek inflationary wage increases and businessmen to seek inflationary price increases.

We feel that recognition of the positive impact of productivity on all of us, a removal of obstacles to productivity improvement and incentives to encourage the productive use of resources would go a long way in improving employment opportunities in this country and lowering the threat of a renewed inflationary spiral.

CONCLUDING REMARKS

As we indicated at the beginning of this statement, we have confined our remarks to areas where we feel our experience provides us with some good insights. We hope that what we have had to say is helpful.

Consumers play a very important role in our economy. We believe we have a good vantage point from which to assess the changing attitudes and purchasing activity of consumers. Whenever our views can be useful we will be glad to make them known.

While not always receiving the recognition it desires, the retailing industry is of increasing importance in our economy. Today one of every six members of our workforce is employed in the retailing sector of our economy. It is important that representatives of this sector of our economy contribute more frequently in forums such as this one.

Mr. SEIBERT. That concludes my statement. I thought you might be interested in some recent sales information. Our total sales in January were, as you would suspect, adversely affected by the cold weather. While we had a sales increase, sales were not as strong as we planned or anticipated. However, last week, the first week in February, our sales turned up and were better than we had originally budgeted. Interestingly, the strongest performance for us were in the central and eastern regions where the weather has been a severe factor.

Representative BOLLING. The central and eastern regions, the areas that were most affected, had the strongest performance?

Mr. SEIBERT. Last week, that's correct.

Representative BOLLING. That is very interesting.

At this point I would like to include a pertinent article in the record that appeared in the Wall Street Journal on Friday, February 4, headed "Cool Customers."

Without objection that will be done.

[The article referred to follows:]

[From the Wall Street Journal, Feb. 4, 1977]

COOL CUSTOMERS: CONSUMERS LIKELY TO STAY CAUTIOUS AFTER COLD ENDS

(By Philip Revzin, Staff Reporter)

INFLATION FEARS MAY DEPRESS RETAIL SALES, SOME SAY; OTHERS ARE OPTIMISTIC

The Effects of "Cabin Fever"

This winter's chill on consumer spending seems likely to linger long after the snow melts.

At least that's the early, and loose, consensus of a number of consumer pollsters, analysts, retailers and some consumers themselves. The effects of the weather were felt abruptly, with as many as two million workers laid off in two weeks. But the recovery will be much more gradual, with effects—particularly rising inflation fears—lingering into the second quarter and beyond.

The first indications of retail-sales trends in the last part of January show that many consumers stayed away from stores and showrooms. Part of the slack was caused by shoppers' inability to get to stores in some areas. In some cases, bad storms kept consumers away, while in others the stores closed or curtailed their hours to save gas. A number of big retail chains reported yesterday that while sales for all of January were up nicely, the gains of the last week of the month weren't up to expectations. The government said yesterday that retail sales fell 0.5 percent last week from a week earlier.

Auto makers reported yesterday that sales for the last 10 days of January were off slightly from a year earlier, which represents a sharp curtailment of recent trends. For the first 20 days of the month, sales had been running about 20 percent higher than a year earlier. Analysts say the bad weather cost the auto makers 30,000 to 50,000 unit sales.

Detroit Is Optimistic.—Some of the more optimistic analysts, including auto-industry officials, expect that the adverse effect on retail spending will be only temporary and that lost sales will be made up later in the year. A General Motors Corp. spokesman, for example, says GM doesn't see any reason to change its previous estimate of 11.2 million passenger-car sales by the auto industry in 1977. A Ford Motor Co. spokesman says: "We're more concerned about production interruption than demand interruption. The weather has an impact on short-term demand, but it shouldn't have any impact on people's transportation needs."

Other observers, however, see longer-term problems. Michael K. Evans, president of Chase Econometric Associates, says that not only will higher fuel costs and loss of income from layoffs cause an immediate retreat in spending but also "consumer attitudes will continue to sour later in the year because of the higher rates of inflation." He adds: "The inflation expectation is starting already as people get the first higher fuel bills, particularly middle-income people and people on budgets. Food prices haven't even shown up yet, and it can only get worse."

In either case, the weather has seemingly kayoed what appeared to be increasingly confident consumer spending. Even a temporary interruption could hurt the recovery of the general economy and might blunt the effects of the Carter administration's stimulus program.

The reasons for the immediate consumer caution are obvious, analysts say: Consumers have less disposable income, and they aren't sure when the situation will improve. Mr. Evans figures that the cold-weather problems will take about $8.5 billion out of the discretionary-spending stream this year. He estimates the total could go as high as $15 billion in the year if the weather stays bad through March and if the summer is dry. This money will go for higher fuel and food costs, he says, instead of for cars, television sets, and other postponable purchases. Mr. Evans says only part of this lost spending can be recovered during the rest of the year.

To individual consumers, the immediate effects of the severe weather are the soaring fuel bills, perhaps a temporary loss of income, and uncertainty, all of which erode spending confidence. George Johnson, a 54-year-old construction worker, blames the abnormal cold stretch in the Cleveland area for prolonging a normal wintertime layoff of a month or two into one that could last four months this year. "We got laid off Dec. 17, where we usually work into January, and we may not get back until April," he says.

This jolt has caused the laborer to put off buying a new car to replace his dying Chevy. "I'm plain afraid to buy a car," he says. "In 30 years I've never seen it so bad, and I don't know when the money's going to start coming in again."

When Will They End.—One major problem with weather-related layoffs is that nobody knows when they will end. William Weatherly, a packer operator at the Bedford Heights, Ohio, plant of Continental Can Co., was laid off Jan. 17, for what he was told would be "just a few days," because the plant's gas supply was curtailed. Now into his third week of unemployment, Mr. Weatherly says he probably won't be called back until March.

Mr. Weatherly and the millions of others laid off because of the gas shortage naturally are hoarding all their resources to buy food and to pay their own higher gas bills. Mr. Weatherly says his last gas bill was for $100, up from a $60 bill at a similar time last winter. "The next one may be $120," he says.

Even without a dramatic income loss, fuel bills are changing many consumers' buying plans. Frank Pavlich, a 28-year-old Cleveland recording-studio engineer, says the bill for gas and electricity for his suburban duplex from Dec. 15 to Jan. 15 was $182, up from about $100 last winter and up from about $60 in warmer months. "This is the first time the utilities were higher than the rent ($150 a month)," he says. This bill and the prospect of an even higher bill in February made Mr. Pavlich give up thoughts of buying a new living-room rug and some better furniture. "I'm going to wait until the summer on the rug," he says.

Events of recent weeks are likely to shake the confidence even of those who haven't yet been badly hurt themselves, economists say. Just as during a recession people who haven't been laid off will curtail spending in fear that they may lose their jobs, there is likely to be a spreading effect from the current energy problems. Workers who see their neighbors jobless or who read of extensive hardship elsewhere feel less secure and confident themselves. The feeling of vulnerability may be particularly acute this time because people realize that their home heat could be cut off and they can't do anything about it.

Pollister Albert Sindlinger says his most recent survey, completed yesterday, shows the biggest one-week drop in consumer confidence he has ever seen. Layoffs, he says, are "depressing attitudes greatly. Some women we're calling are even crying on the phone." Mr. Sindlinger says both short-term and long-term buying plans have been curtailed sharply. His index of positive spending plans plunged to 47.6 percent from 52.7 percent the week before, "wiping out all the gains it had made since the election," he says.

According to most analysts, consumer confidence had been only reasonably good, but was getting better, before the worst of winter hit. The Conference Board, a business group based in New York, says its most recent survey showed a big jump in confidence and buying plan in December, an increase from relatively depressed levels for most of 1976. This reflected renewed optimism about a new administration in Washington, the board said. Now, however, a Conference Board spokesman says the weather "will have a sobering effect, particularly on retail sales. Consumers will tend to be much more cautious than we had expected them to be."

Data Resources Inc., a Lexington, Mass., econometrics consulting firm, also rapidly retreated last week from earlier, and rosier projections. The firm lowered its consumer-confidence index to 78.2 percent for the first quarter from the previous projection of 84.3 percent. The rate for the fourth quarter of 1976 was 86 percent. But Data Resources says it expects the confidence rate to make a comeback, particularly after the Carter administration tax rebates are received.

Forecasters say the timing and magnitude of renewed consumer confidence depend on just when the weather improves, how much stimulus is applied to the economy, and what effect this stimulus and other factors have on inflation. The renewal of confidence also depends on unpredictable psychological perceptions, they add.

"There's no doubt that the immediate impact is really bad," says the chief economist for a large retail-goods manufacturer. "But we attribute most of it to 'cabin fever.' People are cooped up, they can't go out, they get depressed. It's a noneconomic factor, and it's impossible to predict how it will affect people and when it will go away."

"Borrowing Ahead".—Retailers say they are already noticing an interruption in sales, particularly of durable goods like refrigerators and ranges. Some of the immediate effects of consumers' postponing these types of purchases are being offset by continuing heavy purchases of winter goods: auto batteries, coats, boots and scarves, for example. Some analysts caution that these purchases, in effect, may be "borrowing ahead" on future discretionary income that would have been spent on other items later in the year.

A spokesman for Dayton Hudson Corp., the Minneapolis-based department store operator, says that sales for the first three weeks of January exceeded the company's expectations but that volume in the final week was well below what had been expected before the severe weather hit. "We looked at November, December, and first-part-of-January sales and thought that a lot of people were underestimating the strength of the economy," the spokesman says. "The deepening energy crisis hasn't really changed our view on the underlying strength of the economy, but we see a deeper lull in the first quarter."

Reginald H. Jones, chairman of General Electric Co., is among executives who see most lost retail sales being recovered later. "We are experiencing some slowdown at retail, as people go out and visit the supermarket and take groceries they have to have and are willing to postpone purchases that can be deferred," he told a recent press conference. "These postponed purchases will come back . . . unless this thing gets out of hand and goes far beyond any conditions we see now."

But other businessmen and consumer analysts aren't so confident that the effects will be short-lived. For one thing, they say some of the costs associated with the weather-related problems won't appear for a while. "Some higher utility bills won't show up until March or April," notes Mr. Evans of Chase Econometrics. For people who budget heating bills on a level year-round plan offered by many utilities, the big payment will hit householders in June, the settle-up month for many gas companies.

Fears of Inflation.—Furthermore, Mr. Sindlinger says his polling is finding that many people are still paying off Christmas debts, and that the current higher fuel costs will force them to stretch out their payments even further.

Fears of inflation are likely to be another lingering effect, the more bearish consumer watchers say. "It won't be until the second quarter that some of the higher prices for fruits and vegetables begin to be really noticeable," Mr. Evans says. Some petroleum-industry experts say gasoline prices will be sharply higher next next spring and summer because refiners are turning out all the fuel oil they can these days, and won't have as much gasoline in storage for the 1977 travel season as they normally do.

Data Resources now is forecasting that consumer prices in the first quarter will rise at a 9 percent annual rate and expects a 6.3 percent rise for all 1977. That would be up sharply from the 4.8 percent rise in 1976.

Topping it off, newspapers and television have informed people that by fall natural-gas prices are likely to rise sharply, as government price ceilings are relaxed or removed in an effort to get more gas into interstate pipelines.

All this talk about higher prices, particularly if the cost-of-living rise does approach double digits in the next couple of months, could cause consumers to further tighten their purse strings. In the past, inflation fears have discouraged consumer spending about as much as high unemployment.

In fact, some experts say all the media attention on the weather is a key factor in how consumers will react in the future. "In large part, what happens to consumer confidence in the next few months will depend on the flow of news," says Jay Schmiedeskamp, vice president of the Gallup Organization. "Right now, the weather has really caught people's attention." Consumer confidence had been rising, but only slowly, he says, because even before the cold weather hit, "there were financial pressures on people from inflation and high unemployment." Now he adds, with the media spotlight on the price of fuel, "the pressures will seem to be even greater."

Representative BOLLING. Congressman Pike.

Representative PIKE. Do any of you gentlemen feel that a reasonable alternative to Mr. Carter's economic stimulus proposal would be to do nothing?

Mr. LINDSAY. No; I do not.

Representative PIKE. Mr. Kuhns, the problem I have with public service jobs is that they wind up costing, by your own figures, over $10,000 apiece. That is in the public service jobs. Construction jobs cost about $25,000 apiece. When we—of the $10,000 in the public service, only somewhere around $7,500 or $8,000 goes to the worker, and the rest is overhead; but when we pay workers in the public sector at least 50 percent more than the minimum wage in the private sector, how do we ever get them back into the private sector?

Mr. KUHNS. Well, I would expect that the increase in expenditure levels, increased consumption you would have from filling these jobs, would trace its way back into the private sector. At least as well as rebates.

Representative PIKE. I am no exponent of rebates either. In fact, I may well be one who thinks that we might not be much worse off if we did not enact Mr. Carter's stimulus package, although I spoke for it on the Budget Committee.

Don't you have a motivational problem in getting people to work in the private sector as long as we always provide jobs in the public sector which pay them back?

Mr. KUHNS. You mean, I think, generally that the jobs in the public sector would be more desirable than in the private sector?

Representative PIKE. Yes; for those who would otherwise be working at low wages in the private sector.

Mr. KUHNS. Well, there might be many who might work at higher wages as a result of public jobs; that is true. But they would return higher taxes, have larger expenditures for consumption.

Representative PIKE. But they never will be willing to go back and work in the private sector at anything approaching the minimum wage; isn't that correct?

Mr. KUHNS. That might be true.

Representative PIKE. That is all, Mr. Chairman.

Representative BOLLING. Senator Proxmire.

Senator PROXMIRE. Well, gentlemen, I want to thank all of you for very thoughtful and helpful statements. I think that your unspoken response to Mr. Pike was most helpful. You all want to act. You don't agree, apparently, with Mr. Burns that we don't need a stimulus. That is very helpful in view of the fact that two of you gentlemen represent business and appear to disagree with Mr. Burns. I think from my standpoint that is very encouraging.

Mr. Lindsay, you put a great deal of emphasis on permanent tax cuts; and then you also indicate toward the end of your statement that you think it is extremely important that we avoid deeper Federal deficits. You say Federal deficits only perform well if they do not swell total borrowing demands to inflationary levels. We are talking about monetary policy.

How do we pass substantial and permanent tax cuts to stimulate the economy, meet the obligations which you as an outstanding business statesman specify here—and I think your organization represents one of the best—without aggravating the deficit that you fear?

Mr. LINDSAY. This is a real possibility to be afraid of. It is our own view, and we debated this a long time among ourselves, that the direct losses to the Treasury through permanent tax cuts will in time be more than made up by the increased personal income tax receipts and increased corporate earnings, as a result of a stronger growth of the economy than would have occurred without the tax cut.

We recognize that in the short term, a stimulus is required to get off what appears to be a dead center; but we believe that over the long term, tax cuts that reduce the national income that is spent by the Government will produce a healthier economy. I recognize it is a very difficult problem to reconcile these two factors, since they pull in opposite directions. On balance, this is really the result of our joint judgment.

Senator PROXMIRE. Well, it is a "toughie." After all, we can obviously push to a logical position where clearly if we cut taxes we are going to reduce revenues unless the tax cut stimulates a sufficient increase in economic activity so that the resulting taxes will exceed the revenues that we lose through the lower rates. You have to be very careful and selective in the kind of taxes you cut. I just wonder, for instance, now if we increase the investment tax credit, reduce taxes in that area, I think that may be a good proposal, and I think it is important. I am wondering if under present circumstances that is going to really get a great deal more economic activity? Don't you need to have an increase in consumption to, at this point, move into a greater level of utilization of capacity so that there's a combined motivation for businessmen to increase their capital? If I were a businessman, I wouldn't care if you had an investment credit of 30 percent, I wouldn't buy equipment if I didn't think I could use it, if I didn't think I had the market for it.

Mr. LINDSAY. I think you are certainly right, that consumption and capital investment have to go hand in hand. But because of the major increase in employable people expected over the next few years, there needs to be capital investment in advance to create those jobs. Our concern is to get the capital investment going now.

Another possible incentive to investment can be created by changes in depreciation schedules shortening depreciation schedules will have a substantial favorable impact on corporate boards in making capital investment decisions. This would not amount to a subsidy; although it would to some degree allow corporations temporary use of money that they otherwise would pay in taxes at an earlier date. I believe shortening depreciation rates would have a significant effect on boards of directors and corporate managements in making investment decisions. I know in our own company's calculations on major capital investments, these factors are seriously considered.

Senator PROXMIRE. I would like to ask you, Mr. Kuhns, about the distribution of your job promotion program. One of our first considerations should be to put the people who are not at work to work. One way of doing that is by opening up more jobs. The area that seems to me that is so logical for this is housing. You do emphasize housing. You do suggest a substantial increase in tandem money. Unfortunately we have been pushing that. The Banking Committee in the Senate recommended that. The Senate Budget Committee turned it down. I understand the House Budget Committee turned it down. I understand the administration is not interested in pushing this. For the life of me, I cannot understand why. We need the housing. We have had a shortage for three years now. The cost here is the least you can get for a job. It is not inflationary because you have such a tremendous amount of unemployment in the construction trades now; and I just wonder what we can do to get these people both in the administration and in the Congress to recognize that this is a good, efficient, reliable private enterprise way of putting people to work in what I think is likely to be a more permanent way than almost any other.

Mr. KUHNS. I couldn't agree more.

Senator PROXMIRE. Let me ask Mr. Seibert if he would like to comment on that? I didn't see in your proposal here any kind of a housing component either.

Mr. SEIBERT. No.

I do not really consider myself an expert in that area. While our business relates directly to housing, I would not be a good source to tell you how to stimulate housing activity. However, I obviously would be interested in, and supportive of, programs that would increase activity in the housing area.

There is a direct relationship between housing and major segments of our business and we have been concerned about the sluggishness in the housing sector.

Senator PROXMIRE. Mr. Seibert, I was very encouraged to hear your strong emphasis on productivity. That is the only way to improve our standard of living, is to improve our productivity? How do we do it? One way of doing it, of course, is to stimulate the economy. The improvement in productivity has been characteristically there when the economy was expanding. When we were able to keep people at work full time, to hire people for a 40-hour week and they worked 40 hours. You didn't have to keep them sitting around. They worked all the time because there was a job to do. Other countries that have surpassed us in productivity improvement, Japan, Germany, so forth, have done it in my view largely because they have had little unemployment, full use of their resources, or fuller uses of their resources than we have had. Isn't that the fundamental way that we improve productivity? One of the fundamental ways in addition to manpower training?

Mr. SEIBERT. Yes.

I think that is obviously one important element of it. I think another piece of it, though, is to look at the efficiency of industry, of our total system. When you look at Japan, you are also looking at modern plants and equipment in many parts of their economy. One of the points that is central to the remarks that I made on productivity is the need to be more concerned about our efficiency. When I say our, I am talking about the country as a whole as well as each industry and each company. We look at our own company and find that bureaucracy has made inroads. We are looking for more efficient ways to conduct our business. We see the effects of Government on our business. It has affected our productivity. We would like to think that it is also part of a productivity improvement opportunity.

Senator PROXMIRE. I would like to ask just one more question of Mr. Lindsay, if I might. My time is just about up.

Mr. Lindsay, your organization is noted for taking a long view and for not concentrating just on the immediate problem, but looking ahead. Most of the testimony we have received is understandably concerned with the President's stimulus package, economic stimulus package; but the job of this committee is to look at the longer term.

Let's assume that the stimulus package is adopted. Then what? Are you satisfied with the fiscal 1978 part of the package? What would you recommend to keep the recovery going into fiscal 1978 and beyond?

Mr. LINDSAY. We have a series of subcommittees within the CED working now on longer range problems. I have cited some of them. We feel strongly that our particular function in CED is to look at the long range. We believe that solving the energy problem is central to the growth of the economy. We believe—and I express this as a personal opinion—that Government has intervened in the economy in such a great number of separate individual actions that no one knows the total effect of these interventions. I believe that probably a third of our economy, or half the private sector, is really so influenced through a variety of Government interventions—individual piecemeal interventions—as to create a serious question as to whether the marketplace or the Government now makes the essential economic decisions.

It may be possible that the Government can substitute this very large number of individual interventions with a few more general interventions to guide the overall economy. Within such a general framework, most of the individual decisions could then be left to the private marketplace.

I would agree with your comment, sir, about the growth of bureaucracies. I think bureaucracies grow in corporations just as rapidly as they do in Government, and even in universities. [Laughter.]

This is one of the problems of productivity. Large organizations break the problems into tiny little hunks, and nobody ever sees the overall. Each one is trying to solve a special problem. The net effect is to reduce overall productivity substantially. I am not sure I am responsive to your question, sir, but these are the directions that we in CED are going to be examining in the next 2 or 3 years.

Senator PROXMIRE. Thank you, Mr. Chairman.

Representative BOLLING. Senator Javits.

Senator JAVITS. Mr. Lindsay, I would like to welcome you here. Mr. Lindsay and I are very old friends. He has worked with me for many years in these economic fields. I am delighted to see you here speaking for the CED.

I would like to ask you just one question. We have in mind the possibility of some special tax benefit or even a subsidy for employing the hard core unemployed, those who have been unemployed 26 weeks or more; comparably, we have in mind some arrangement with business regarding youth unemployment. Mr. Seibert, I notice you deal with that in your statement.

I have been very strong on not compromising the minimum wage. Therefore, we would have to work out some kind of a training allowance as is done, for example, in the on-the-job training under CETA.

Could you gentlemen contribute to our thinking on these ideas, or any others to deal with expected targeted governmental measures for these very heavily impacted groups, the hard core unemployed, and youth? Could you start, Frank?

Mr. LINDSAY. Senator, a CED group under John Burns is now working on the employment of the young, the old, the disadvantaged, and the minority groups. This is a real problem. Increasingly I think that the single unemployment figure is a very deceptive measuring stick.

The problem is getting at the really hardcore, the real problem areas, both by geographical area and by age and education.

I would certainly support measures—and I believe they are called for—to assist in getting at this. I have some real concern, however, that it be done in a way that is simple to administer, is reasonably effective, and does not create another large Government bureaucracy to administer the program.

A principal test of every alternate measure that is proposed should be simplicity of administration and overall effectiveness. We should not create yet another set of people who are going to audit payrolls and who try to check who is qualified or who isn't. We also have to prevent some abuses on the private side which have happened in the past.

We hope that we will have some hard policy recommendations for you in this area soon.

Senator JAVITS. How soon?

Mr. LINDSAY. I think it probably will be 6 to 9 months, but I am guessing.

Senator JAVITS. Six to 9 months, forget it.

We will be on something else.

Mr. LINDSAY. I will convey this to the chairman of the subcommittee.

Senator JAVITS. I certainly wish you would. We need it now. If you do it in 9 months, it will be for the next recession.

Mr. Seibert.

Mr. SEIBERT. Senator, if we focus on the unemployed youth and the hardcore unemployed that you refer to, we first of all would have to recognize that a job must exist for which they will be trained. We have looked at this and have restricted ourselves to our own company to see what we could do. In preparation for this testimony we did identify those jobs in our company for which we could train unskilled, unemployed young people.

I referred in my statement to the fact that the number of jobs would not be great, but we feel that in our company alone there would be 1,000 or more, perhaps 2,000, such jobs for which we could train these unskilled people. We would welcome the opportunity to participate in a program that would address the training of these people; but we would also like to participate fully; that is, we would like to participate in the design of the program, too. Our past participation in some training programs has been less than satisfactory in that we were only a participant. I suspect this is our own fault for not becoming more fully involved.

Senator JAVITS. Do you have any clear idea as to what incentive you would need? Or would you just do it provided it is properly coordinated and pays at least the minimum wage without any inducement?

Mr. SEIBERT. Well, I think an inducement would stimulate more activity, because it goes back to existing jobs. We do not currently have an employment problem. We are able to find people for the jobs that are available. We hire essentially unskilled people for many of our jobs, and we do train them on-the-job or through our training centers. I think an incentive would stimulate efforts to do something for this particular group to which you refer.

Senator JAVITS. Well, do you have any suggestions? What we are looking for is practicability.

Mr. SEIBERT. I would share I believe your view that some subsidy or some support of the training activity itself is required. I also share your view that the minimum wage should not be tampered with.

Senator JAVITS. During the training stage you would want some participation in its cost?

Mr. SEIBERT. Yes.

Senator JAVITS. Mr. Kuhns, I just have one question of you. I gather from reading your statement that you don't have any specific figures on the rebate proposition.

In other words, you are suggesting a jobs program, and the rebate does not figure largely or even at all in your calculations?

Mr. KUHNS. That is true. We simply have a view that the immediate impact of the rebates might just be frittered away.

Senator JAVITS. The jobs are the key.

Mr. KUHNS. Jobs are solid.

Senator JAVITS. Do you agree with these other gentlemen on the need for a reduction in the tax rebates? Would that do any good in terms of stimulating buying by your members?

Mr. KUHNS. A reduction in the long-term tax rates?

Senator JAVITS. Yes.

Mr. KUHNS. Once they got accustomed to a little more stable, better standard of living, it might have some effect. I would say a long-term tax rate reduction might be a consideration of the total tax reform package.

Senator JAVITS. Thank you so much.

Thank you, Mr. Chairman.

Representative BOLLING. Congresswoman Heckler.

Representative HECKLER. Thank you, Mr. Chairman.

Mr. Lindsay, I find myself in support of your basic thesis in your statement before the committee; however, I am—having read this statement—still at a loss as to how to actually implement the policy goals that you have expressed. You stress the need for the development of a long term coherent strategy, that will strengthen business and consumer confidence, minimize uncertainties, and provide assurances that short term stimulative measures will not overshoot their mark. Yet it must remain compatible with the longer run needs for efficient allocation of resources, price stability, and budgetary discipline. So what you are saying is that while we deal with unemployment now, we must avoid inflation in the future; and we must avoid having this stimulus go beyond our temporary goals to reignite the pressures that caused the recession in the beginning. Now, I agree with all of this, but the trick is in how to do it.

Another point you raise constantly and I find is mentioned by all business leaders in my district is this question of uncertainty. Business can't deal with uncertainty. We tie your hands if the future is not clear. How can business invest and how can decisions be made? We are faced with uncertainty right now as we look at the President's proposals on stimulating the economy and creating jobs. We don't wish to reignite inflation; at the same time, we do wish to fight the sluggishness that we see. What mechanisms can we develop to achieve that magic balance? What would you advise us to do?

Mr. LINDSAY. I think we have laid out some of them here. Certainly we should not put excessive reliance on monetary policy, as has been done in the past.

Because of failures in fiscal policy in the past, monetary policy has been called upon to do far more than it can. This has resulted in great fluctuations in interest rates which have had a serious impact on confidence and on decisions on the part of consumers and on the part of industry. It has produced a yo-yo effect on the housing industry. This is clearly one area where government policy can be improved. In this correction, the development of the new congressional budget process is a very great step forward.

Representative HECKLER. In relationship to the President's proposal, do you think that goes far enough, does it go too far? How would you rate this in terms of achieving your overall goals?

Mr. LINDSAY. Your question really is, is this the right sized package?

Representative HECKLER. Right. If we really want to avoid reigniting inflation, are we going too far? Are we doing enough? These are the questions we are asking ourselves.

Mr. LINDSAY. My personal opinion is that the size of the package that is being talked about is not, during this period, running a serious risk of reigniting inflation. But the effectiveness of the package is more qualitative than quantitative. If it is to have continuing effect beyond the true horizons of the package, as Senator Proxmire asked, then it must do those things that continue to keep the economy going. It must create a climate for increased capital investment. And as I mentioned earlier, a reexamination of depreciation rates and a shortening of depreciation periods would do a great deal toward freeing business to make decisions for expanded investment. It would reduce the uncertainty about the degree of inflation in the long-term future.

If one is planning a plant that will be in existence for 20 or 30 years—a real question is whether the payback over this period will be in dollars so depreciated in value that the investment is never recovered fully?

In the energy field, I think a whole series of measures needs to be taken. Here the leadership of the Government is particularly important. We have all talked about a coherent national energy strategy. I think there is a great need for an energy plan, particularly in the Northeast where we both live. I am not sure I am being responsive to your question.

Representative HECKLER. You are.

It would seem from your prepared statement that in order to achieve the long-term certainties that you definitely advocate a permanent investment tax credit rather than the present proposal; is that right? You feel that the President's proposal to increase the investment tax credit from 10 to 12 percent is a further incentive, but not quite enough; is that right? Or not quite firm enough?

Mr. LINDSAY. That's right.

We also believe that the Congress should consider revising depreciation schedules for capital investment. We are less sure about the 4 percent social security tax credit.

Representative HECKLER. The 4 percent you have misgivings about; is that it?

Mr. LINDSAY. We have less confidence in the effect of a one-time cut. It really is questionable how much effect it will have on employment.

Representative HECKLER. What do you think the $50 tax rebate is going to achieve? The Library of Congress speculated the other day that the average family would spend $139 more for fuel this year.

I think considering our temperatures in Massachusetts, that is a low estimate for the increase. A family of four receiving $200 would find at least $140 wiped out by the added costs of fuel. What stimulus is that $50 rebate then going to provide? Is it going to do very much in terms of the economy?

Mr. LINDSAY. It is my feeling that it may be a one-time stimulus that may already have been eaten up. It might simply be used to replenish savings or repay excessive debt that has been incurred by people in paying their fuel bills.

Again as a personal view, I would favor a form of negative income tax to take care of hardship over the long run.

Representative HECKLER. A further issue you stress in your testimony, and one that is raised constantly, is the question of overregulation. I hear from virtually all the business leaders in my district and wherever I go that the regulations are strangling them, that they are duplicative, time consuming, and costly. I also find a very different attitude among the regulators. In Fall River, Mass., where we have the textile industry, I find EPA has sent a special task force to the district and really had constructive talks. These people had a very cooperative spirit in terms of the business needs of those who were present; and I think that the new regulations will reflect some kind of a compatibility between ecology and technology.

I see EPA and some of the other agencies expressing sensitivity to perhaps the charge of overregulation and the need to regulate fairly; but how can we bring these pieces together?

I am doing it in my district. Other Members are doing it in their districts. Do you business leaders at a high level ever deal with agency leaders and so forth? Isn't it possible to have this dialog occur before there is a crisis in some business sector or in some locale?

Mr. LINDSAY. Well, we are trying to do this at CED, specifically in two areas. We have a committee that has just been organized under Bill Eberle to look at the whole range of regulation. As part of our normal CED process, we invite as participants both economists and academic specialists and——

Representative HECKLER. How about Russell Train? Do you invite Russell Train into any of these meetings?

Mr. LINDSAY. We certainly do. I would like to say Elmer Staats, the Comptroller General, often participates in our meetings. We have the highest regard for him.

Representative HECKLER. A final question.

Mr. Seibert, I think private sector jobs are more desirable than public sector jobs, because I don't think the public sector jobs often lead to any career futures. In terms of training, how can we avoid abuses by the private sector? This is something that we are faced with in the Congress. How can we draft a law that will assure that the private sector does not take advantage or abuse Government programs that are designed to provide temporary assistance for training which will, hopefully, lead to future careers?

Mr. SEIBERT. That is a tough question. We have talked about that. Some of the proposals that you hear about, I think would create some difficult problems.

Representative HECKLER. The tax credit proposal, for example? The Javits proposal?

Mr. SEIBERT. There could be a control problem or an audit problem. I don't know that I have an answer for you today on that. We have recognized the problem. It would vary from business to business, depending upon the turnover in the number of people that you bring in via a training program. I would not view it as a problem for our company. We could be talking about one or two thousand jobs probably; and as I mentioned to Senator Javits when he was here, without some kind of stimulation or participation, it is likely that we would continue filling those jobs from available applicants. There simply is not, for most of these jobs, currently a shortage of available people.

If I could, I would like to comment on two of the questions that you put to Mr. Lindsay. Our experience with the last stimulation package in 1975 was that it did flow positively into general merchandise retail sales over a period of about 2½ months. There was a measurable impact which we have quantified in our written statement.

Our view is that while we support in our statement a permanent tax reduction, much of any rebate would find its way into the economy through retail sales.

My personal view is that the consumer is very adaptable and that by April or May, the higher heating bills will have been handled by most people. We are seeing the effects of these higher heating bills right now in our sales. We will have absorbed the effect of the higher fuel bills in the months in which they occurred.

There may be some hangover, but I suspect most of it will be behind us by April or May.

In the area of regulations, the whole subject is obviously very complicated and very complex. We would like to participate as would other businesses in trying to get at some of the unnecessary aspects of it. We are now in the process of trying to discover the costs to our company of compliance with Government regulations that have been imposed since 1970.

We are nowhere near a conclusion of that study. However, at this point it appears that our costs of complying with such regulations are equal to the cost of constructing enough new store space for 600 people.

There is significant cost there. While our costs are only one aspect of it, we could be helpful in addressing that point.

Representative HECKLER. I would appreciate hearing any of your further reflections on the question of how to avoid abuse by the private sector. I personally would like to see much more involvement and reliance on job opportunities in the private sector. Of course, that would require that the added positions not be those that would have been filled anyway. The added positions should offer an incentive to businesses and an incentive to the job recipient who could go on and then be trained. We don't want to substitute one for the other for what this would do otherwise.

I thank all three of you.

Representative BOLLING. Before Mr. Pike left for rollcall, he left a note for me to ask a question that he would like to ask of Mr. Lindsay and Mr. Seibert. He wanted to know if a 2-percent increase in the investment tax credit would cause Itek or J. C. Penney to build one additional building that they are aware of? Or I presume make any investment—any additional investment?

Mr. LINDSAY. It is hard to answer. I think it might.

Representative BOLLING. It might?

Mr. LINDSAY. I am thinking of some plans that are now underway. The larger credit probably would not make a great deal of difference for us if we were not contemplating an expansion program or were up to a decision point as to whether or not to expand. However, we are at that point now in a couple of situations. It is conceivable that it might make the difference as to whether to go ahead or not. But I do not think it would induce us to go out and build a new plant that we haven't even thought about building before.

I think we probably would be more influenced—that is, as the balance would be tipped more—by a change in depreciation.

Representative BOLLING. Mr. Seibert.

Mr. SEIBERT. Our expansion of store space is more closely related to our debt to equity-ratios and our general financing capability.

The actual effect on our company of the 2 percent added investment tax credit or the 4 percent social security offset comes out about the same and would equate in dollars to about 200,000 square feet of additional store space. I do not think that enactment of this would cause us to sit down immediately and review our expansion plan and add another store or two.

I think the fact that we would not have to borrow that money would improve our financial situation. We likely would end up having added that kind of space over the next several years.

Representative BOLLING. I guess the followup on that is how much difference would it make if it were temporary or permanent?

Mr. SEIBERT. If I could answer that, I think it has been said before here that uncertainty is difficult to deal with in a planning sense. We would certainly favor things of a permanent nature that could be built into our planning process. The leases that we are currently negotiating go to about the year 2010. When we put up a large catalog distribution facility, we are looking at a 30- to 40-year life. We are interested as much as possible in things we can count on.

Representative BOLLING. Mr. Lindsay.

Mr. LANDSAY. I might make a further general observation. Corporations by and large operate in terms of capital investment on multiyear schedules and plans, so that the feedback as a result of changed external conditions, such as a temporary tax credit, could be very slow.

In the normal corporate organization, expansion plans involving major commitments to investments go through pretty extensive scrutiny at the divisional and operating management levels as well as board levels. There may be some incentives to stop a project if there is a recession. That can happen fairly quickly; but the impact of incentives to approve new programs takes some time to work through the system so that the changed economics in terms of impact on balance sheets, borrowing capacity, impact on profits, return on investment take a while to work through the structure.

This is why we feel a permanent change will be more effective than a temporary one. In other words, it is unlikely that many people would say a temporary extra 2 percent will make a difference in their investment decisions. I am not sure that many people would react to that.

Representative BOLLING. Thank you.

Senator Proxmire.

Senator PROXMIRE. I would like to ask each of you gentlemen—we might start off with Mr. Kuhns on this—the Ways and Means Committee, Mr. Kuhns, is considering an alternative, a business tax cut based upon increases in employment. The administration opposes that proposal and they oppose it, as I understand it, for a couple of reasons. One is that this would benefit the thriving, prosperous, big firms like General Motors, compared to American Motors, because they would be hiring people and American Motors probably would not. That scores with me because American Motors is in my State in a bigger way than General Motors is.

The second way would be it would be encouraging additional workers be hired instead of using the present workers more intensively. For that reason, it would perhaps have a perverse effect upon productivity. The way productivity would be improved, of course, is to use your existing work force fully. There would be less incentive to do that if you got an additional incentive for hiring somebody else to come in and do the job that your existing force is doing.

What is your view on that modification?

Mr. KUHNS. This is Mr. Ullman's proposition?

Senator PROXMIRE. Yes, sir.

Mr. KUHNS. In my view, this is just another form of subsidy in whatever form it comes. There are alternative ways of providing subsidies. I think you are probably correct that in this case, it would come only with the hiring of new employees. I think in some cases, productivity would go down, because you are not using the existing resources.

Like any short-term subsidy of that sort now, I can't see its concentrating its effect upon part of the economy where we really need it.

Again, in the case of a plant that is on the margin, as was suggested in some of the previous questions and answers, deciding whether you want to go to a new investment, or expand a little bit, this might—if they are on such a margin, this might provide the additional incentive. Flip it over, and all right, they will push it up.

I can't see a long-range sustained effect of this.

Senator PROXMIRE. Mr. Lindsay.

Mr. LINDSAY. I would agree with the administration's arguments as you have stated them.

Senator PROXMIRE. Mr. Seibert.

Mr. SEIBERT. I would support that, too. I see many, many problems in the approach and little incentive.

Senator PROXMIRE. Mr. Seibert, you have been very candid in your statement, saying that the investment tax credit or the social security tax credit that President Carter has proposed would do relatively little to generate additional jobs in 1977. In your judgment, would expanding the size of those tax reductions have an appreciable effect?

Mr. SEIBERT. Not if you restrict it to 1977 or even 1978. Our business and most businesses really, could not react that fast.

Senator PROXMIRE. What do you think would be the best short-term measure the Federal Government could adopt to stimulate more jobs in the private sector?

Mr. SEIBERT. Well, that is a multifaceted question. It requires a similar answer.

Whatever is done that will stimulate the economy in general, including the consumer sector, will pick things up. I favor a stimulus of some kind that will lift consumer confidence even beyond the current improved level.

Senator PROXMIRE. You think the best thing then is permanent tax reductions?

Mr. SEIBERT. This would be my view, yes. I would support that, plus the kinds of things that you and others are considering for longer term incentives, for capital formation and for expansion of our economy. In the short term, I think the stimulus to the consumer sector will have the most immediate effect.

Senator PROXMIRE. Mr. Lindsay, Mr. Seibert, I didn't detect much concern on your part—and I think it is very interesting, because you are both very able and thoughtful businessmen, and you work with business people—much concern over the prospect that we are likely to have serious inflationary pressures with the stimulus package that the President has proposed. Is that a correct conclusion?

Mr. SEIBERT. Yes.

Mr. LINDSAY. I would agree with that in terms of the present stimulus program; but in terms of a little further out, I think we are very much concerned that unless capital investment, particularly in the basic industries, is increased, shortages of basic materials, basic metals, steel, copper, paper, and so forth will again occur; and that this can trigger another inflation round. One of the problems is that there is a longer and longer leadtime to add the capacity or modernize it. We should find ways to get projects underway that are now on the drawing board. Now is the time to make major expansions rather than when the economy is up against the stops and we would be taking resources out of the economy to support a major construction boom just at the time when we need the output of the added capacity.

Senator PROXMIRE. I wonder if this is true. The staff of the committee tells me they were struck with your concern about material shortage and they wonder whether or not you can really support it?

They feel some changes in American business and in the Government policy may have created a situation which will reduce, to some extent, those shortages in the future.

First of all, capacity expansion in basic materials industries which tended to lag in the 1960's they say, and early 1970's has caught up considerably since then.

The smaller car—and it is true we are shifting to a bigger car now—but I think we will be moving back—means a sharp reduction or decline in the market that in 1973 consumed over 20 percent of our steel. Sharp increases in fuel efficiency, which is mandated now by law, coming on as the years go on, means a peak out in the demand for gasoline by 1980 and a subsequent long-term decline.

Heavy emphasis is now being placed on energy conservation and other areas, gas legislation that were required. The phaseout of lead in gasoline eliminates a very important market for this material. Smaller cars using smaller tires, you put much less wear on them. Auto uses of zinc. Over 30 percent of zinc's consumption is being reduced for weight reasons.

Could it be that the growth in demand for those basic materials would be relatively slow in the future and could this also help to account for why business investment is so slow to pick up?

Mr. LINDSAY. I think, in some sectors there may be some validity to this argument; but on the other hand, when there are changes in energy availability—this in turn will generate requirements for other materials. For example, in the housing industry, I would expect requirements for capacity to produce insulating materials to go up very substantially.

Senator PROXMIRE. Any indication of any shortage, though? Insulating material has been reasonably available and moderately priced.

Mr. LINDSAY. Not currently that I am aware of. I would like, if I may, to send you some further materials on this prepared by a series of executives of major materials companies in which their view is that we are looking toward shortages again.

Senator PROXMIRE. You set forth in your statement a proposal that we should have 6 percent real growth over the next year or so; is that correct?

Mr. LINDSAY. Over the next 2 years, averaging about 6 percent.

Senator PROXMIRE. Do you think that the Carter proposal will enable us to achive that? Is it enough?

Mr. LINDSAY. I think it may be enough to get back on the 6-percent line again. I am not an economic forecaster, but I would certainly not go beyond that until it is clearer than it is now that it is not enough.

Senator PROXMIRE. Many economists feel that it would not give us a 6-percent growth over the next 2 years. You are cautious on it and you would wait and see; is that it?

Mr. LINDSAY. I think so, yes.

Senator PROXMIRE. Now, Mr. Seibert, you gave us, I think, the most optimistic reaction I have ever heard to this fuel shortage. You say that based upon the facts that business has picked up, and in spite of the cold snap, in the areas that have been hit the hardest by the cold snap, the Midwest and Northeast, you have had a good business. That is mighty good news. It is surprising. People must be coming in and buying an awful lot of overcoats, galoshes, sweaters, and so forth.

Perhaps they are buying more food to keep warm. The way they keep warm is to eat more.

Mr. SEIBERT. Of course, there have been purchases of cold weather-related goods. I would have to say as of today, they are not buying much of it, because there isn't much left.

My remarks that you characterize as optimistic relate, I think, to my experience over the last several years relative to the consumer who is far more adaptive than I think we have sometimes realized.

We looked at the behavior of our customers as they got their own finances in shape during 1974 and 1975.

Senator PROXMIRE. Let me interrupt to say the reason I read that is yesterday I read a piece in the Wall Street Journal that pointed out people now don't know whether they are going to have a job to go to. They don't know whether they will be laid off or not. In many cases, they don't know whether the cold snap will continue. They don't know when they go home at night whether they will have a warm house or cold house. This uncertainty and unease the Journal reporter indicated was contributing to a more pessimistic attitude on the part of the consumers, and particularly I would think that it might apply to business people who see now that they have to shut down their plant, wondering whether or not they can keep the plant going with another cold winter, perhaps next year, and therefore, maybe reducing their plans that they might have otherwise had for expansion.

Mr. SEIBERT. I think you can make a case for that, but I come back to the resilience and the adaptability of the consumer to circumstances. We see it in our own sales, our own activity in our sector of the economy.

I continue to feel that by the time we get to April and May and the Sun is shining and the birds are singing that this current situation will have been absorbed.

Obviously, it comes out of the economy somewhere; but I believe that the consumer will make the adjustment and that barring some other catastrophe, we have probably seen the worse of it from a psychological standpoint. There are individuals that are obviously affected more than others. Those who are unemployed, or at home because their plant is shut down, have a serious problem.

Senator PROXMIRE. Incidentally, I want to say that your observation that we had the biggest increase in real Gross National Product growth in 21 years last year really surprised me. I checked—I asked the staff to check it out in the President's Economic Report and you are absolutely correct. I am amazed. I didn't realize that at all.

It is a very interesting fact and something we should not ignore. Of course, it is very largely—and I think the reason I have that reaction, is that so much of it came in the first quarter. The first quarter was so tremendous that all together we had a 6.1-percent real increase.

You have to go back to 1955 to find a year in which we had that kind of growth in 1 year. It is a very helpful factor to keep in mind.

Thank you, Mr. Chairman.

Representative BOLLING. Congresswoman Heckler.

Representative HECKLER. I would like to ask Mr. Kuhns a question.

I am very concerned about unemployment, deeply so. At the same time, I am also concerned about the stimulus that you support in your statement, the $30 billion program.

Do you not feel that this could possibly reignite inflation and bring us back to where we were at the heart of the recession?

Mr. KUHNS. If you are looking toward long-term economic objectives, there are a great many of the objectives included in the statement from the Committee for Economic Development that are really difficult to disagree with.

The problems ultimately as you expressed them are the problem of getting full use of resources without inflation and getting increased expenditures and at the same time getting reduced taxes and having these done without an increase in deficits and so on.

For long-run stability, these may be all very desirable objectives; but we look upon this current situation as what you might call a bootstrap operation. There have been other similar ones.

For example, the one in 1961 or 1962 when the tax rates were reduced, everybody was so amazed at the course of the recovery afterward that the returns for those reduced tax rates were increased, and it worked.

I think we look at this situation in very much the same light, that the conditions are different, and there are other problems to be met; but again we feel that the increase in total expenditures in a heavy shot this way will, in effect, lift the economy up by its bootstraps and engender the increased income that will produce the larger tax revenues, perhaps even at lower tax rates.

Representative HECKLER. What about the prospect of going from the frying pan into the fire?

Mr. KUHNS. Well, of course, if everybody rushes hard enough, it is possible. We don't feel with the current 15 to 20 percent unused capacity in this country that there is a tremendous immediate danger if there is some kind of restraint put on price rises—barring these out-of-proportion increases in energy prices; that's always a possibility.

Representative HECKLER. Would you please repeat the last statement?

Mr. KUHNS. I said barring increases that are out of proportion to other prices in energy prices, there would not necessarily be a tremendous inflationary impact.

Representative HECKLER. Are you saying we should have price restraints?

Mr. KUHNS. No. In the case of the energy prices going up, a large part of this is what you would have to describe as noninflationary.

In other words, no matter how high they get, at least part of it is due to changes in real prices, relative availability of this resource or relative demand for it, or both have changed sufficiently so that the real price structure has changed; and all of this, of course, goes into the increase in prices as we call it; but in that sense it is not all completely inflationary.

Part of it undoubtedly is; but these changes in real prices can affect the effectiveness with which a given program might work in securing our recovery.

Representative HECKLER. Would you suggest the $30 billion for the jobs portion of the package and then the rest of the package as the President has proposed it?

Mr. KUHNS. In terms again of the reductions in tax rates, we think this ultimately can be a good idea if it is coupled with a general bill on tax reform. I think——

Representative HECKLER. Are you talking about a permanent tax reform now?

Mr. KUHNS. Right. I think permanent reductions in taxes coming in the fashion in which they are proposed will not have as much effect.

Over a period of time they would have more effect once they become dependent upon it.

During that time, we would hope that there could also be considerable tax reform that might incorporate these tax reductions along with them.

Representative HECKLER. Thank you, Mr. Chairman.

Representative BOLLING. I suspect the House may have a rollcall fairly soon. I will take a little time. Let me know when I have used 10 minutes.

Mr. Lindsay, as we said earlier, the CED has been interested in full employment budget calculations and how these might be used in formulating budget policy.

As you know, the outgoing Council of Economic Advisers revised upward the estimate of full employment.

This in turn would have changed the full employment budget calculation.

Have you and your staff had an opportunity to review these estimates?

I would suspect not.

If that's the case, would it be possible to ask you to take a look at that particular approach? One of the dilemmas that we have on this committee today is illustrated by that.

There was a time—I guess in the 1950's—when we worked out among us some sort of agreement as to the terms of debate on policy.

Now with the last blow of the outgoing council, we don't even have a real agreement at all on what is full employment.

I think there are a variety of those kinds of things that we are going to be needing assistance on in arriving again at a position where the terms for debate are understood by everybody and we are not arguing over statistics.

Mr. LINDSAY. I think this is a very important question. You are quite right. We haven't reached a conclusion on it. We would be delighted to respond subsequently.

Representative BOLLING. I think that, of course, takes you back to what is the nature of the change in the labor force and the whole range of things that perhaps leave us almost incapable of arriving at policy conclusions like those that had so much to do with the effectiveness of the employment act in the 1950's, and at least the early 1960's.

I think we are in a period where we very badly need the kind of input from groups of good will and reasonable objectivity on all sides of issues to get back to a point where we politicians are talking about something that is meaningful.

Mr. LINDSAY. I think the great problem is the use of a single number for unemployment. It hides an awful lot of things, both good and bad. You are quite right. We need to reexamine the whole thing, because a single number in the headlines, day after day or week after week, may be misleading to all of us.

Representative BOLLING. Thank you for the cooperation on it which I expected.

Mr. Seibert, I am concerned and interested in exploring your attitude. We are grateful for your detailed analysis of the effective 1975 one-shot tax rebate based upon your concrete experience in dealing with the recipients of monetary retail sales. But after indicating that the rebate was a defective stimulus, you concluded a permanent tax cut of about the same overall size would be preferable.

A $50 tax cut spread over the whole year would mean a withholding reduction of only $1 a week. I take it you really think, however, that permanent cut would have a better immediate effect? Or is it a better long-run effect?

Mr. SEIBERT. Our view is that a better long-run effect would be desirable at this point in time, that conditions are different today compared to 1975 when the one shot stimulus did, I think, lift the consumer and was effective.

We do not see the consumer in the same mood or the same condition today, and we think that a longer-term stimulus would be more effective.

Representative BOLLING. I would like to ask all of you to respond, if you will, to a question that has no real answer, but I would just like an opinion.

I have come to the conclusion, and I suppose all of you have, that a great deal of what happens in the economy is not related to reality. It is based on psychology; nad I am curious as to what your guess is as to the effect on the psychology of both the consumer and the investor of the weather that we have had in this country in the last few months?

Now I am aware that that weather has been extraordinarily good in some areas, extraordinarily bad in others; but the so-called "good" includes areas where there is a good deal of drought; and the bad, of course, is obvious.

I am curious about your reactions as to what the psychology of the consumer will be and what psychology of the investor might be?

I will start on the left with Mr. Kuhns.

Mr. KUHNS. Actually, a couple of us were talking about this earlier this morning before I came over. We were concluding that there are a number of our industries if the weather would persist this way for a number of seasons, they would probably begin moving.

I don't know if there is going to be any long-term effect like this, but certainly any of the plants that are affected by the energy costs in the Northeast and in the Midwest are eventually going to think about something like that.

Representative BOLLING. Another unfair advantage for the Sun Belt.

Mr. KUHNS. Right.

As far as consumers are concerned, I would imagine that a large number of them in the Northeast and the Midwest are going to increase some expenditures for insulation, for tighter windows, for more efficient heating equipment and everything related to it, if it keeps up that way.

I suppose some of their consumption patterns otherwise, even the manner in which they eat, might change some, too. Of course, that is a fairly long-term change in the weather pattern. I don't think it is expected to be that way.

Representative BOLLING. I don't think anybody knows quite yet whether we have that or not. Although some predict real change.

Mr. LINDSAY. I think in the short term, in terms of this winter and its crisis, the problem could pass fairly rapidly as far as consumer confidence or investor confidence are concerned, if there are no secondary effects.

I think it is too early to tell whether stocks held in inventory, in-process inventory from one plant to another, are of sufficient magnitude not to impact in a secondary way on the rest of the economy, or whether the situation will be comparable to a major strike that lasts over several weeks, say in the steel industry, and causes users of steel to exhaust their inventories and then produces secondary effects.

If that secondary effect does not occur, I would think that the effect might pass fairly quickly.

In the longer term, I think again one of the points is confidence as far as investment is concerned and I assume you are speaking about real investment and not the stock market——

Representative BOLLING. Right.

Mr. LINDSAY. The feeling of confidence depends on a feeling that there is a strategy and that there is a national, Federal Government-led energy policy, so that shortages are not going to be a recurring pattern.

If that confidence is to be reestablished, we need to know where we are going over the next 10 or 15 years in terms of energy, through more effective use of energy, through conservation, through solving more quickly the tradeoffs between costs to the environment and costs of protecting the environment. I am not one of those who just think we ought to go hellbent ahead with nuclear plants without considering future problems; but we need better ways of arriving at a more sensible balance.

Energy is by far the key to the next 15 years; and the Government has to participate in a strong way in providing confidence that energy supply is reasonably under control.

Representative BOLLING. In effect you are saying that most industries and businesses cannot simply look ahead with any feeling that they know what they are looking at until there is a known and established overall energy policy?

Mr. LINDSAY. Yes. That is exactly right.

Representative BOLLING. And that makes it so that energy is destabilizing in at least two major respects?

Mr. LINDSAY. In the real sense of current operations and in the future sense of making commitments.

Representative BOLLING. Thank you.

Mr. Seibert.

Mr. SEIBERT. Well, I would support those views. Clearly, from a psychological standpoint, we are going to be in better shape if we know that we are on some defined track. I think short term, I have expressed myself as I see the consumer this year.

I have tried to restrict my views to the effect on our business and on our company.

Without being able to see into the future, from what we look at right now, I think that there is some improvement with the exception of those consumers that are still affected.

You mentioned the last several months. Specifically, in our business, in December the west coast was a little soft because of abnormal weather. The rest of the country was very vigorous from a sales standpoint. We have had the sales pattern in the last several weeks that I described earlier. I think that from an overall standpoint, I sense a more constructive, a sober approach to solving some of these problems.

On a national basis, while uncertainty is difficult to deal with, I think we do go ahead with our plans, assuming that many of these things will be solved. We look back in history and we find all kinds of crises that we confronted and resolved.

I think if we adopt a wait-and-see attitude toward expansion and growth, we would be in real trouble. So we do proceed as pragmatically as possible. We are encouraged by some of these things that we see happening.

Representative BOLLING. Your optimism is based upon the miraculous fact that the country has survived for 200 years?

Mr. SEIBERT. Exactly.

Representative BOLLING. I think it is a reasonable position.

Do I still have some time? My time is up; I will not ask any more questions.

Senator PROXMIRE. Go ahead. You haven't taken any time at all.

Representative BOLLING. All right. This time I will surprise you and go ahead.

Mr. Lindsay, you mention in your prepared statement that growth of the real GNP that averages about 6 percent for the next 2 years will help not only reduce unemployment, but will help cut inflation as well.

Many of our witnesses and members have been concerned that such rapid growth might revive inflationary pressures. Would you explain how the growth performance would work against the inflation?

Mr. LINDSAY. I think that in the short term, as the economy expands, it becomes more productive, as long as it doesn't hit the stops of capacity limits. When that occurs—and what we were really referring to here in the statement is the longer run investment—it can contribute to reducing inflation not only in expanded capacity, but also in modernizing capacity.

I would like to say that Senator Proxmire is absolutely right; that improving the productivity of this economy is just incredibly important.

A lot of the investment does not necessarily involve expanding capacity, but improving productivity. We have been one of the slowest among industrialized countries in modernizing our equipment—I can't quote the exact numbers, but perhaps Mr. Kuhns can—the percentage of machine tools over 10 or 15 years old is probably higher in the United States than in any of the industrialized countries.

Representative BOLLING. Mr. Seibert, the International Trade Commission recently sent to the President a recommendation to put import controls on nonleather footwear. Others have called for controls on other kinds of apparel and on textiles in general.

How would such an action affect the retailing sector and the consumer?

Mr. SEIBERT. The effect on retailing and the consumer, as it relates to footwear, would be on price levels. Average unit prices would go up. We would also see some reduction in assortment offerings. I think generally speaking you would see a similar effect in most of the areas where these proposals are being made.

The effect would be more pronounced on the lower priced merchandise.

Representative BOLLING. Thank you.

Now I have a question for all of you and it concerns the statement of one of the senior gurus in our city. Speaking last Thursday before the House Banking Committee, Arthur Burns painted a rather optimistic picture of the present economic situation.

He said, for instance:

> Despite some weakening in the pace of business investment in fixed capital, the physical volume of final purchases—that is all purchases of goods and services except for additions to inventories—rose an annual rate of almost 5 percent in the fourth quarter. This was the most rapid advance of any quarter during 1976.

Again looking at the positive side, Mr. Burns stated:

> With employment growing more rapidly, the volume of personal income during the fourth quarter rose at an annual rate of nearly 11 percent, half again as fast as in the previous 3-month period.

As you know, Arthur Burns also labeled the President's recommendations for fiscal stimulus to be "premature."

I would like each of your reactions to the Chairman's statement. I guess I will start with Mr. Seibert.

Mr. SEIBERT. Well, in a way I think we responded to that question in our prepared text. We have approached 1977 in our planning—as far as general merchandise retailers are concerned—as an improving year, a good year.

We are looking for increases in sales of about 11 percent and roughly half of that will be real growth.

We have not seen any significant problems in 1977 as we looked at this particular year. We are investing significantly in new plants this year; and we are seeing, we think, the confidence level of the consumer moving up steadily.

There is a problem in some parts of the country currently due to the weather. We view that as an aberration. We have a fair amount of confidence in 1977 as far as our business is concerned.

Representative BOLLING. Thank you.

Mr. Lindsay.

Mr. LINDSAY. I will respond both in terms of the company and in terms of CED.

With respect to the company, our annual operating plan—in the commercial side of our business—which is about 70 percent of our total business—is based on an assumption of a moderate improvement. We expect a moderate improvement in sales. In reply to your question, I might recount a CED meeting at which the report that we have submitted to you was discussed at great length by most of the 60 members of our research and policy committee.

I was surprised in chairing that meeting to find that without an expressed exception by any of the members, they felt the time had come for stimulus, that enough of the returns were in.

This was in November. Enough of the returns were in so that we at CED felt we should recommend a program of stimulus for a faltering economy.

Representative BOLLING. Your message is clear.

Mr. Kuhns.

Mr. KUHNS. One of the things that you can always say about Mr. Burns' statements is that his facts are always correct. It is true that the real income level has increased. Real consumption has increased, certain amounts quarter to quarter, year to year since this recovery.

I think what really concerns us most about this is that the economy can be functioning relatively well and growing for most people.

If you look at 90 percent of the economy, or 85 to 90 percent of it upon which to measure unemployment, it is doing very well.

What really concerns us is this at the same time may very well go on indefinitely and leave the other 10 to 15 percent out of it completely.

I think it is perfectly conceivable that some time we may have an economy in which 85 to 90 percent of the people are getting along just fine, living well, doing well; and the other 10, 15 percent may just be completely forgotten.

We really have 10-percent unemployment out there. There are the 7 to 7½ million that are on the rolls, but there are all of the other people that quit looking. They are not even statistics any more.

Representative BOLLING. Well, in that connection, isn't it true that this is probably the most luxurious recession, even though it was the worst since the depression that this country has ever seen?

There were a number of people, millions of people, who were without a job and in great trouble, but there were a great many other people who didn't cut back on a thing.

It is really a phenomenon I think, and all you have to do is be a fisherman on Chesapeake Bay to see that phenomenon.

Senator Proxmire.

Senator PROXMIRE. I would just like to point out to Mr. Lindsay that the notion that we can, after having had in 1976 a 6.1-percent increase in the real GNP, have that for 2 more years, hallelujah, it will be great except we haven't done that since in the Korean war.

I have spent the last half hour calculating this. The best period we had in the 1970's so far was 1972 through 1975 when we had a 9.5-percent increase in those 3 years.

In the 1960's, we had—in the Vietnam war—we had an increase of 17.1 percent. That would be less than you are suggesting we should have over the next 3 years.

In the Korean war, we had 20.6-percent increase in 3 years then.

So this is a very ambitious and I think welcome proposal, but I just wonder if the $15.1 billion stimulus in a $2 trillion economy is really going to do anything like that.

Mr. LINDSAY. That is a hard question to answer.

I should point out that we really had this growth rate in mind for a 2-year period. We started from the assumption that to take care of the added employable people—the people that were coming into the labor force—a net increase for this sort of growth is going to be required.

Senator PROXMIRE. That is exactly right. That should be a very welcome thing for our country. More people want to work. They can produce more. We should be able to have a great improvement in everybody's well-being.

Mr. LINDSAY. We really strongly reject the idea that we cannot have reasonably full employment and control inflation at the same time.

It is simply an admission of failure on both the public and private side of our economy to say it has to be one or the other.

Senator PROXMIRE. Thank you, Mr. Chairman.

Representative BOLLING. Thank you.

Gentlemen, we are very grateful to you for your appearance, your presentations, and your answers to our questions. It has been a great help. We thank you.

[Whereupon, at 12:25 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 10, 1977.]

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